

CSUITE

INSIGHT

THREE PEOPLE WHO MATTER IN WASHINGTON, D.C.

HOW RECENT STATEMENTS BY **PRESIDENT OBAMA**,
SENATOR CHRISTOPHER DODD, AND **SENATOR CARL LEVIN**
MAY BE SHAPING THE FUTURE OF EXECUTIVE PAY

**HOW TO REWARD PERFORMANCE
WHILE ON THE ROAD TO RECOVERY**
(Hint: Think Long-Term)

WHAT CAUSED THE ECONOMIC CRISIS?
(The Roots Run Deeper Than You May Think)

**THE INSIDE SCOOP ON CEO
PAY STRATEGIES AND BONUS PLANS**

SEYMOUR CASH RETURNS!
(And He Is Upset!)

Interviews with the Experts
LUCIAN BEBCHUK: THE GOVERNANCE EXPERT
MIKE HALLORAN: THE STRATEGIST
IRA KAY: THE WRITER AND ANALYST
THOMAS WELK: THE LEGAL EAGLE



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— AND —
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LETTER FROM THE PUBLISHER



David has led Equilar from a pure start-up since its inception in 2000 to one of the most respected and trusted names in the executive compensation industry.


RECOVERY

WELCOME TO THE second issue of *C-Suite Insight*. The issues surrounding executive compensation are bigger today than ever before. 2010 promises to be a seminal year, with numerous compensation-related regulations under consideration as part of the financial reform bill. Amidst this landscape, we're excited to present the second issue of *C-Suite Insight*. We'll be releasing this issue just as our 2010 Executive Compensation Summit is being held in Washington, D.C. The timing and venue couldn't be more appropriate.

When we began planning for our Summit last year, we quickly settled on Washington as the ideal location. In the aftermath of the "Great Recession," you're more likely to hear a conversation about executive compensation in the halls of Congress and The White House than on Wall Street! The reform package remains controversial, and I expect a number of lively debates at our Summit. We've tailored this magazine to present a balanced picture of executive compensation and related topics, without an undue focus on Wall Street scandals and Washington politics.

As the economy begins its recovery, it's time for company boards and top executives to move from crisis containment towards a less frantic, if still very intense, view of the longer term. Our cover story, for example, discusses the imperative to think long-term when it comes to pay strategies, and contains several interesting nuggets from Equilar research that we originally developed in cooperation with *The New York Times*.

Once again, a highlight of *C-Suite Insight* is our interviews with leading experts, including Lucian Bebchuk (Harvard Law School), Thomas Welk (Cooley Godward Kronish LLP), Mike Halloran (Mercer), and Ira Kay (formerly of Watson Wyatt, and now Managing Director of Pay Governance, LLC). Just a few of the topics we discuss: the structure of compensation committees, the role of compensation consultants, the impact of SEC regulations, how the components of CEO compensation packages continue to evolve, and, of course, a little bit about scandal on Wall Street.

If you're in attendance at our Washington Summit, please try to find me and say hello. I place tremendous value on interacting with all of you who are able to attend. If you can't make it to Washington, then please enjoy this issue of *C-Suite Insight*, and feel free to contact me with any comments. 



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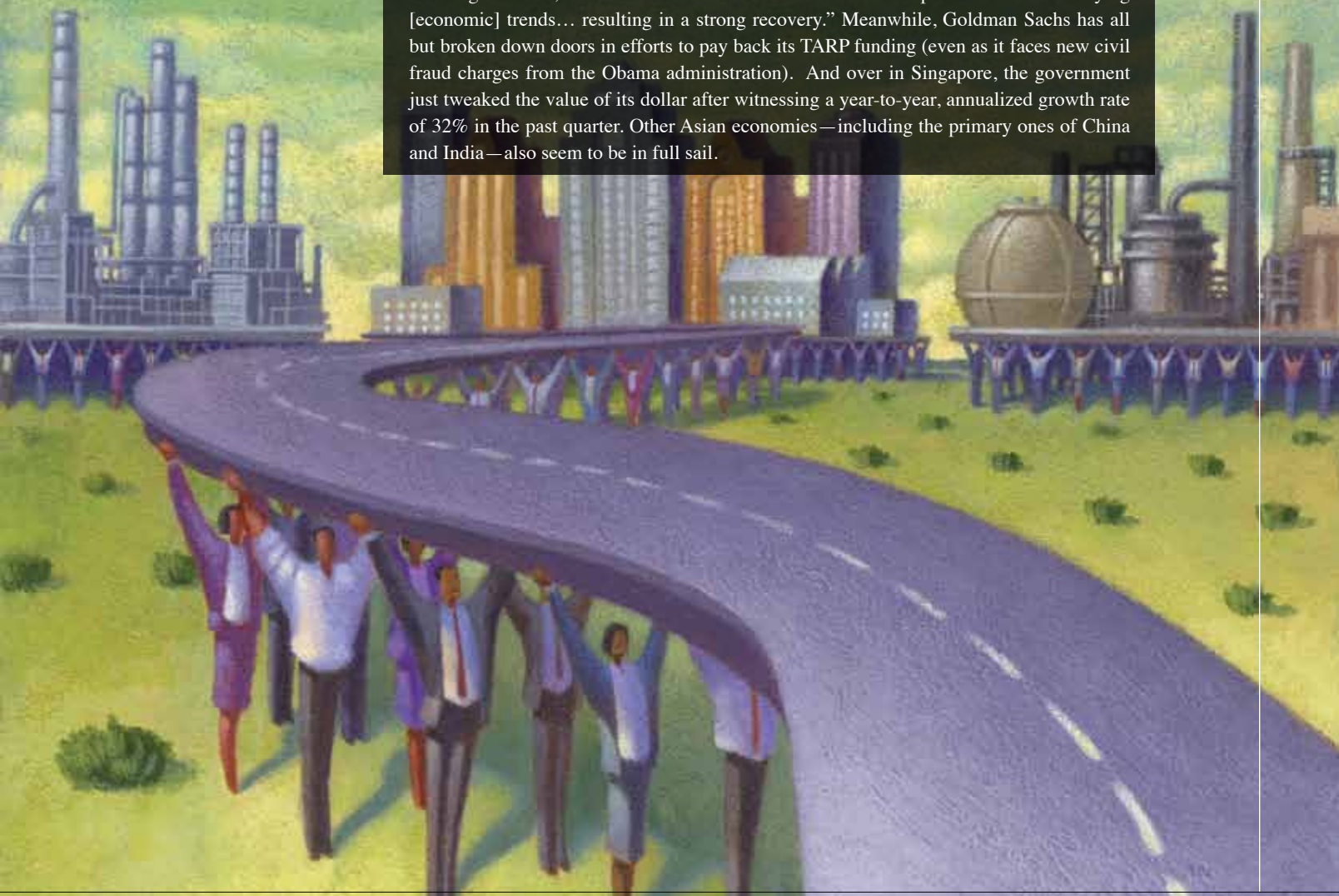
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How to Reward Performance While On the Road to Recovery

(HINT: THINK LONG-TERM)

FED CHAIRMAN BEN Bernanke recently testified to Congress that the U.S. economy is now “on a path to moderate recovery.” He said his fears of a double-dip recession have lessened significantly in recent months. Jamie Dimon, chairman of JP Morgan Chase, has said he sees “clear and broad-based improvements in underlying [economic] trends... resulting in a strong recovery.” Meanwhile, Goldman Sachs has all but broken down doors in efforts to pay back its TARP funding (even as it faces new civil fraud charges from the Obama administration). And over in Singapore, the government just tweaked the value of its dollar after witnessing a year-to-year, annualized growth rate of 32% in the past quarter. Other Asian economies—including the primary ones of China and India—also seem to be in full sail.





STEVE JOBS TOOK
**\$1 IN TOTAL
 COMPENSATION,**
 AND ENGINEERED A TOTAL
 RETURN OF 63% DURING AN
 INCREDIBLE YEAR DRIVEN BY
 THE iPhone, AND DRIVING
 HIS OWN STAKE IN THE
 COMPANY TO MORE
 THAN \$1 BILLION.

Into this climate of optimism comes Oliver Stone's new film *Wall Street: Money Never Sleeps*, some 23 years after the original movie and its protagonist Gordon "Greed Is Good" Gekko presaged the catastrophic 1987 market crash. The film is set in the burning residue of the 2008 financial-services meltdown. Gekko, who has recently been released from prison, spends the entirety of the film trying to warn the financial industry of the coming crisis.

Real business is hardly a movie. Yes, it has been fun over the years to watch an endless parade of nasty, greedy businessmen—in addition to Gekko, your favorites might include those played by Lionel Barrymore (*It's a Wonderful Life*), Fred McMurray (*The Apartment*), Ned Beatty (*Network*), and even Suzanne Pleshette (as Leona Helmsley in *The Queen of Mean*). But the reality of everyday business life is less about snappy one-liners and more about endless meetings, reports and small fires to be put out, contentious hours on the phone, and the occasional company-threatening crisis. Choosing the person to lead a public enterprise, and paying this person appropriately, is a very important task, but alas, not one that makes for good screenwriting fodder.

C-Suite Insight is primarily focused on executive compensation, not hiring practices and not corporate culture. Yet choosing top executives—and supporting them—is part of the overall business process. How should companies determine who is in charge, now that it appears that the economy is on the road to recovery? And how should their overall pay be determined?

THE PAST IS THE FUTURE

We can start with a simple statement: "Past performance is not an indicator of future results."

This statement is nothing more than routine legal boilerplate in the financial-services industry. We've read it so many times that it's lost any meaning it may have ever had.

It's a lie.

Past performance is an *excellent* indicator of future results—maybe the *most important* indicator.

We choose doctors, dentists, and lawyers based on past performance. We select neighborhoods and schools based on past performance. We buy our cars, our appliances, our insurance, even our toothpaste, based on past performance.

And corporate boards select their CEOs based on past performance. Maybe they choose a person who has steadily risen through the company, excelling at every level, or perhaps they snag an executive from a leading competitor.

Sometimes the pick is made for certain political or public-relations purposes. There have been many disastrous picks, to be sure, related to bad luck, ineptitude, or even criminal behavior.

The fact remains that the board will choose—and compensate—its CEO and other top executives based on past performance. The difficulty lies in determining how to measure performance, if it can be measured at all. The founder/CEO and the cult that often surrounds these people can further complicate the issue.

DOES TOTAL COMPENSATION EQUATE WITH TOTAL RETURN?

While they might get a lot of attention, perquisites are simply the dessert of executive compensation packages, not the bread and butter that you'll find in the areas of base salary, bonus, stock grants, and stock options.

Oracle's Larry Ellison, who received \$1.5 million in perks, also had the highest total pay package in 2009, at \$84.5 million; this included \$78.4 million in options. Comparatively, perks make up a very small part of his pay package.

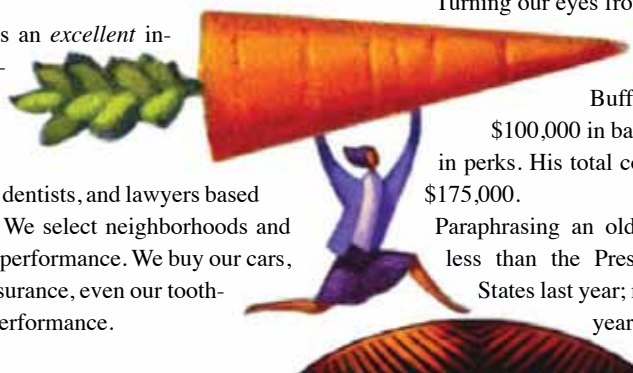
CEOs are often judged by comparing their total compensation with the company's total return. Doing the math, we find that Ellison earned his money (including a \$3.6 million bonus) as Oracle was experiencing a total return of -14% for the year.

Compare that to the 25% return that HP enjoyed under CEO Mark Hurd, whose total compensation was \$24.2 million, including a bonus of about \$16 million.

Hurd's total compensation was actually down about \$10 million from the prior year, most of it taken from his bonus.

Turning our eyes from Oracle to "The Oracle," we find that Warren Buffett received a mere \$100,000 in base salary and \$75,000 in perks. His total compensation was just \$175,000.

Paraphrasing an old witticism, he made less than the President of the United States last year; maybe he had a worse year. Or maybe not: Buf-



fett's company, Berkshire Hathaway, rolled out an ROI of 3%, while profits rose 61% from 2009.

Buffett's compensation is essentially meaningless, given his Berkshire ownership stake of about \$40 billion.

Steve Jobs's compensation picture offers a similar view. He took \$1 in total compensation, even as he engineered a total return of 63% during an incredible year driven by the iPhone. He increased his own stake in the company to more than \$1 billion.

When Jobs left Apple in 1985, the company had annual revenues in the \$2 billion range; the company and Jobs had been icons for a decade by then. When Microsoft made its famous \$150 million investment in Apple in 1997, Apple's revenues were in the \$7 billion range.

Apple stayed in the doldrums for several years afterwards, and couldn't sustain consistent growth until 2005—and the mainstreaming of the iPod. Since then, Apple has eclipsed its previous revenue peak of \$11 billion in 1995, reaching just shy of \$14 billion in 2005. Its revenue shot up to \$32 billion last year, and is on course to exceed \$40 billion this year.

Steve Ballmer did not start Microsoft, but as a college buddy of co-founder Bill Gates, he has been there almost from the beginning. He has had a total compensation package in the \$1.3-\$1.4 million range in the past two years, reflecting relatively tough times for the company. Microsoft's total return in 2009 was -12%.

As with Buffett and Jobs, Ballmer's ownership stake of about \$10 billion obscures whatever compensation package he may have. Ellison, of course, also retains a very large ownership stake in the company he founded, with holdings worth about \$22 billion.

THE FACT REMAINS THAT A BOARD WILL CHOOSE—AND COMPENSATE—ITS CEO AND OTHER TOP EXECUTIVES **BASED ON PAST PERFORMANCE.**

THE ROLE OF OPTIONS

Intuitive wisdom says that if you have a large ownership position—major skin in the game—you are therefore incentivized not to take excessive risk, because you have an enormous downside that accompanies any upside you might have.

Compare this to options, which are all upside, and it's easy enough to think that options encourage excessive risk.

Stock options are a favorite scapegoat for critics of executive compensation, and the term itself reputedly drives the dynamic, risk-taking culture of Silicon Valley. When things go bad, as they did for technology in 2001 and financial services in 2008, stock options are often cited as a big part of what went wrong.

PERKY, **NO MORE**

A look at the Top 200 CEO pay packages, with data developed by Equilar and recently reported by *The New York Times*, offers a treasure trove of interesting information.

The most headline-grabbing aspect of the total compensation package is perquisites, and a look at perquisites throughout the Top 200 list finds a large range of philosophies on the subject—almost an extreme one.

While many companies lavish hundreds of thousands of dollars in perks—largely classified as “security,” but also thrown toward personal use of corporate aircraft, club memberships, and in one case, “a physical”—other companies are completely averse to dispensing perks in today's image-conscious environment.

“The idea is, look, these folks are making plenty of money, they can pay for their transportation, their golf, and stuff like that,” one leading attorney in the exec comp field recently told us during a discussion of perquisites.

Larry Ellison, Oracle's charismatic founder/CEO, received almost \$1.5 million in perks last year. Meanwhile, just 20 miles away, John Chambers at Cisco received less than \$10,000 in perks. Yet the two jobs are fundamentally the same: large, global market leaders with a continuous need innovate and evolve.





Yet it was a lack of profits, and a culture that valued initial public offerings (IPOs) above all, that drove the dot-com express off the cliff, and options seemed to play almost no role in the more recent financial-services meltdown.

A number of experts we've interviewed on this topic pointed out that the individuals who lost the most in the 2008 meltdown were the financial-services executives themselves, as they had the highest individual ownership stakes, i.e., the highest number of actual shares, not options.

These experts are also quick to say there is no correlation between options and failure associated with excessive risk; "the data just doesn't support it" is a statement we hear over and over on this topic.

Regardless of these debates, options continue to serve as a key component in total compensation. In fact, recent data by Equilar concludes that options remain the most prevalent equity vehicle by a significant margin.

THINK LONG-TERM

The data seems to validate the idea of long-term thinking. Past performance is an indicator of future results. But this past performance needs to be long-term past performance.

An investment of \$1,000 in Oracle when it went public in 1986 is worth more than \$300,000 today, despite a calamitous drop in 1990, the dot-com meltdown, and the overall stock-market troubles in 2008-09. So long-term Oracle shareholders don't begrudge Ellison anything; everyone has made a lot of money with Oracle over the years.

Furthermore, CEOs are often hired to create, maintain, or change a corporate culture. Oracle's is famous for its strategic aggressiveness and operational aplomb in integrating complex acquisitions into its operations.

How should other companies proceed in the area of corporate culture? Although it's very common for compensation committees to define peer

HIT IT DOWN THE MIDDLE

Most of the compensation examples for founder/CEOs are extreme and come from the technology sector. These extremes make for fun cocktail-party talk, but aren't helpful in determining total compensation at other companies.

Most CEOs, board members, and compensation experts will tell you there is no such thing as a "typical" company or pay package. That said, can we learn anything from looking at the middle of the pack in the Top 200 list?

There is a group of about 25 CEOs grouped in the median area of the table, with compensation in the \$7 million range. In looking at this group, let's circle back to total return. What correlation can be made between total return and performance?

Huntsman's Peter Huntsman led the Top 200 in 2009, with an impressive total return of 240%. Yet the company's revenue fell almost 25% from the prior year, and profit was down 76%. What's going on here?

Two things, it appears. One, the company was the subject of a round of buyout rumors from 800-pound gorilla DuPont. Two, chemical companies looked stable in a year in which anything deemed risky was generally avoided.

Another good total return performer in this group was International Paper, at 130%. Revenue was down about 6% in this \$20-billion+ enterprise, but there was almost a \$2 billion positive swing in profits, reaching around \$600 million, after the company took a loss of more than \$1 billion in 2008.

Yet CEO, John V. Faraci, made 31% less in 2009, primarily due to a dramatically lower bonus. Why?

Nike's Mark G. Parker saw his total compensation dip from \$7.6 million to \$7.1 million, as the company's shares saw a return of -15% during the year.

Moving first into a lower pay bracket, then into a higher one, we find two interesting cases: Winn-Dixie stores, which increased its CEO's pay from \$2.9 million to \$4.6 million despite a total return of -22%, and Campbell Soup, which raised its CEO's total pay from \$9.6 million to \$11.6, with a total return of -12%.



companies as those that most closely match the business, there is also an effort to define companies with which they compete for talent. The latter group may differ slightly from the core group, but perhaps not dramatically.

Perhaps it should. Lou Gerstner came to IBM from the food business, famously stating that “the last thing this company needs is a vision.” This turned out to be Gerstner’s way of getting the pesky media off his back so that he could, in fact, incorporate a new long-term vision and way of doing business at IBM. Gerstner’s run at IBM is considered one of the greatest in American corporate history.

Stories like Gerstner’s increase the notion of the celebrity CEO, something that’s been with us a long time and will always be with us. Yet even celebrities must have real talent when it comes to business.

Later, “The HP Way” was lost when its board tried to bring in a supposedly market-savvy CEO who could change the company’s reputation from its famed “if it sold sushi, it would market it as cold, dead fish” past. A few appearances with rock stars later, the company brought in an unassuming operations specialist (and surprisingly great salesman) who restored order, if not explicitly The Way.

This leads to the idea of “the time teller” versus “the watchmaker” as approaches to the CEO job.

Steve Jobs was said to be the ultimate time teller, i.e., the person who exerts such obsessive control that no one else will be able to run the company when he leaves. Yet Jobs did leave for several months recently, due to illness, and the market supported the idea that Jobs has put in a team that can run the company perfectly well.

Members of the original Intel management crew (Gordon Moore, Robert Noyce, Andy Grove) were said, with their egalitarian cubicles, to have been watchmakers, yet the company has struggled in recent years.

Microsoft is famous for its legions of managers who bob back and forth when they talk, in the manner of Bill Gates. Steve Ballmer does no such thing, but turn your head when he’s speaking, imagine the volume turned down a bit, and you will hear Bill Gates talking. Microsoft’s culture did not change with the transition from Gates to Ballmer; what will happen in the next transition, though?

Moving out of high-tech, one can easily find charismatic founder/CEOs, ranging from historical figures like Henry Ford, Henry Luce, the DuPont family, William Paley, and Walt Disney, to modern titans like Rupert Murdoch, Phil Knight, Howard Goodman, Fred Smith, Howard Schultz, Herb Kelleher, and many others.

All of these older companies have survived, and mostly prospered, since their founders moved on. We can probably surmise that the same holds true for the newer companies. Because, in the overall scheme of things, the majority of public-company CEOs are “hired hands,” there to do the job and be compensated in the millions, not to accumulate wealth in the billions.

PAST PERFORMANCE IS AN INDICATOR OF FUTURE RESULTS — IF YOU LOOK AT MORE THAN A YEAR OR TWO INTO THE PAST.

So the best advice in determining whether a CEO is effective—whether they’re a company founder or hired hand—is to simply look at the numbers over the long haul.

Past performance is an indicator of future results—if you look more than a year or two into the past. The formula is simple: compare the performance of a CEO to others with similar success over a number of years, see how these other execs’ packages are structured (and whether there are any exceptional provisions in them), and work to maintain a balance of components.

And try to keep the golf out of the total compensation. This should be easy enough, as golf may not be as popular over the next several years as it has been recently. ■

FROM THE NATION'S CAPITAL: HOW ARE THINGS SHAKING OUT?

AN UPDATE ON WHAT **THREE PEOPLE
WHO MATTER** ARE SAYING



The Great Recession, as it's now known, was precipitated by a dip in housing values that ended up knocking down a very large house of cards. Specifically, mortgage-backed security derivatives were the instigators of the "September Surprise" of 2008 that panicked the entire business world, and no doubt played some role in elevating Barack Obama to the White House. Now that many economists, government officials, and commentators have (cautiously) deemed the recession over, it's worth taking a quick look at the fallout. Said fallout is coming from Washington, D.C., where members of the legislative and executive branches are falling over each other to assign blame and create future-proofed fixes. This fallout will ultimately play a role in how boards of directors and their compensation committees determine executive compensation for years to come. We've tried to wrap our heads around all of the conversations. It's difficult to do so in a climate in which every dawn has the potential to bring stunning, relevant local news (the Goldman Sachs indictment), or stunning and relevant international news (beware of bearing gifts to Greeks). For a publication like *C-Suite Insight*, the heft and authority of our nature as print media can quickly be undercut by news that broke after press time. Yet we have forged on. We've tried to understand the entire situation. And we've come up with recent statements by Three People Who Matter on Four Topics that Matter, as our way of synopsizing What It All Means. Herein are recent statements by President Obama, Senator Christopher Dodd, and Senator Carl Levin. Among all the voices in Washington, these three carry the most weight in shaping the future of many aspects of running a public corporation, including how executives are paid.

PRESIDENT OBAMA



SENATOR DODD



SENATOR LEVIN



TOPIC: THE MELTDOWN VS. THE GREAT DEPRESSION

President Obama (in a speech on Wall Street in late April)

“[The] crisis... nearly dragged our economy into a second Great Depression. More than 8 million people have lost their jobs. Countless small businesses have had to shut their doors. Trillions of dollars in savings have been lost -- forcing seniors to put off retirement, young people to postpone college, entrepreneurs to give up on the dream of starting a company.”

Senator Dodd (in a statement introducing the reform bill now known as The Dodd Bill)

“Americans have faced the worst financial crisis since the Great Depression. Millions have lost their jobs, businesses have failed, housing prices have dropped, and savings were wiped out. “

Senator Levin (in his opening statement in special hearings in late April)

“Millions of Americans have lost their jobs, their homes and their businesses in the recession that the crisis sparked, the worst economic decline since the Great Depression. Behind every number we cite are American families who are still suffering the effects of a man-made economic catastrophe.”

TOPIC: THE ROLE OF GREED

President Obama

Referred to an “ethic of greed” during his 2008 presidential campaign. Didn’t specifically mention the word “greed” during his Wall Street speech, but most headlines reporting the speech did use that word.

Senator Dodd (on the Senate floor in late April)

“[American] families have seen millions of jobs lost, trillions in savings wiped out, because of the greedy few on Wall Street who gambled with money that didn’t even belong to them.”

Senator Levin (speaking about the hearings he is heading)

“Running through our findings and these hearings is a thread... that thread is unbridled greed, and the absence of a cop on the beat to control it.”

TOPIC: THE ROLE OF RISK

President Obama (in a speech on Wall Street in late April)

“As you know, part of what led to this crisis was [people] who were making huge and risky bets, using derivatives and other complicated financial instruments, in ways that defied accountability, or even common sense.”

Senator Dodd (in his summary of The Dodd Bill)

“[The bill] eliminates loopholes that allow risky and abusive practices to go on unnoticed and unregulated. Over-the-counter derivatives are supposed to be contracts that protect businesses from risks, but they became a way for traders to make enormous bets with no regulatory oversight or rules and therefore exacerbated risks.”

Senator Levin (speaking about the hearings he is heading)

“[One bank in particular] didn’t just make loans that were likely to fail, creating hardship for borrowers and risk for the bank. [They] also built a conveyor belt that fed those toxic loans into the financial system like a polluter dumping poison into a river. The poison came packaged in mortgage-backed securities that [the company] sold to get the enormous risk of these loans and their growing default rates off its own books, dumping that risk into the financial system.”

TOPIC: **BONUSES****President Obama** (in a speech on Wall Street in late April)

"Americans don't begrudge anybody for success when that success is earned. But when we read in the past, about enormous executive bonuses at firms even as they were relying on assistance from taxpayers, it offended our fundamental values."

Senator Dodd (in his summary of The Dodd Bill)

"Wall Street has developed an out of control system of out-of-this-world bonuses that rewards short-term profits over the long-term health and security of their firms."

Senator Levin (in introductory remarks to his hearings)

"Mortgages and mortgage-backed securities began to be produced for Wall Street instead of Main Street. Wall Street bond traders sought more and more mortgages from lenders in order to create new securities that generated fees for their firms and large bonuses for themselves."

WHEN WE READ ABOUT ENORMOUS EXECUTIVE BONUSES AT FIRMS —
AS THEY'RE RELYING ON ASSISTANCE FROM TAXPAYERS —
IT OFFENDS OUR FUNDAMENTAL VALUES.

TOPIC: **HOW TRANSPARENCY CAN FIX THINGS****President Obama** (in a speech on Wall Street in late April)

"Reform would bring new transparency to many financial markets. [In the past], many practices were so opaque, so confusing, so complex that the people inside the firms didn't understand them, much less those who were charged with overseeing them."

Senator Dodd (a section of his website's summary of The Dodd Bill)

"During the financial crisis, concerns about the ability of companies to make good on these contracts and the lack of transparency about what risks existed caused credit markets to freeze. Interconnected trades, coupled with the lack of transparency about who held what, made unwinding the 'too big to fail' institutions more costly to taxpayers."

Senator Levin (in a press release)

"Senators Chuck Grassley and Carl Levin have introduced legislation to close a loophole in securities law that allows hedge funds to operate under a cloak of secrecy."

"The Hedge Fund Transparency Act of 2009 would clarify current law to remove any doubt that the Securities and Exchange Commission has the authority to require hedge funds to register, so the government knows who they are and what they're doing."

(Note: The bill was introduced in 2009. It currently sits in a sub-committee, along with more than 100 other pieces of proposed legislation.)

TOPIC: SAY ON PAY

President Obama (in a speech on Wall Street in late April)

“Wall Street reforms will give shareholders new power in the financial system. They will get what we call a say on pay, a voice with respect to the salaries and bonuses awarded to top executives. And the SEC will have the authority to give shareholders more say in corporate elections, so that investors and pension holders have a stronger role in determining who manages the company in which they’ve placed their savings.”

Senator Dodd (in his summary of The Dodd Bill)

“Giving shareholders a say on pay and proxy access, ensuring the independence of compensation committees, and requiring public companies to set policies to take back executive compensation based on inaccurate financial statements are important steps in reining in excessive executive pay.”

(Note: The bill calls for a non-binding vote on executive pay, a vote referred to as “a powerful opportunity.”)

Senator Levin

In response to a written question from Senator Levin, Mary Schapiro, who now heads the SEC, said, “Executive compensation has been a concern of mine for some time now. I believe that it’s an appropriate measure to give shareholders an advisory vote on these matters.”

TOPIC: THE VOLCKER RULE

President Obama (in a speech on Wall Street in late April)

“The [Dodd] bill would also enact what’s known as the Volcker Rule, which places some limits on the size of banks and the kinds of risks that banking institutions can take. This will not only safeguard our system against crises; this will also make our system stronger and more competitive by instilling confidence here at home and across the globe.”

Senator Dodd (in his summary of The Dodd Bill)


“[The Volcker Rule] requires regulators to implement regulations for banks, their affiliates and bank holding companies, to prohibit proprietary trading, investment in and sponsorship of hedge funds and private equity funds, and to limit relationships with hedge funds and private equity funds.”

Senator Levin (in a press release about his amendment to strengthen the proposed rule)

“The [strengthened] measure would require large nonbank institutions to set aside additional capital to cover the risks of speculative activity, and prohibit financial firms from betting against their customers. It would toughen a sweeping rewrite of financial regulations currently being debated in the Senate.”

TOPIC: DECEPTION

We’ll close by shifting focus to the SEC, which will be tasked with implementing most of whatever new legislation comes out of Congress and is signed into law by the President. We think this very dry statement expresses the prevailing sentiment in the halls of power in Washington very well.

In its lawsuit against Goldman Sachs, an SEC press release notes, “The [derivative] product [over which Goldman Sachs is being sued] was new and complex, but the deception and conflicts are old and simple,” said Robert Khuzami, Director of the Division of Enforcement. 

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WHAT CREATED THE FINANCIAL CRISIS?

The chart on the opposite page shows one viewpoint of [the underlying] root causes that led up to the economic meltdown in 2008

*The information is provided by Ira Kay, formerly of Watson Wyatt, now Managing Partner at Pay Governance
(For more insight on Ira's thoughts, see his interview with C-Suite Insight, starting on page 37 of this issue.)*



ROOT CAUSES

- 1 US Policy to Increase Home Ownership (Barney Frank, Bush, Fannie Mae, CRA)
- 2 "Easy Money" from Fed (low interest rate)
- 3 China Buys Up \$3 Trillion in US Treasury Bonds (fueled by US trade deficit against China)*
- 4 Non Recourse, Tax Deductible Residential Mortgages*
- 5 Desire for "riskless" superior returns by pension funds and financial services firms*
- 6 Institutional Moral Hazard from Government Guarantees (Explicit: FDIC Implied: "Too Big to Fail"*)
- 7 Elimination of the Glass-Steagall Act
- 8 Rapidly Growing US Economy*

INTERMEDIATE / PROXIMATE CAUSES

- 9 Flawed / Fraudulent Mortgage Underwriting*
- 10 Creation and Explosion of CDOs (effectively separating the underwriters from stakeholders who are concerned with default risk)*
- 11 Flawed Risk Models and Management Value at Risk*
- 12 Flawed Ratings by Moody's / S&P*
- 13 Inadequate Regulation and Oversight*
- 14 Recourse Rule (allowing lower capital requirement under Basel for CDOs than mortgages)
- 15 30 : 1 Leverage by Investment Banks*
- 16 Explosion of Credit Default Swaps*
- 17 Executives with Moral Hazard?
- 18 Traders / Originators with Moral Hazard*
- 19 Consumer Borrowing Frenzy*
- 20 Mark to Market Accounting*

INTERMEDIATE CAUSES

- 21 Explosion in Mortgages Written from 2002 to 2007*
- 22 Housing Bubble (2000 to 2007)*

OUTCOMES

- 23 Financial Crisis 2007, 2008, and 2009+ (\$3 trillion in assets wiped out – Lehman, Bear, Merrill, Wamu, etc.)*
- 24 Deep Economic Collapse 2008 and 2009+ (sharp sustained decline in housing and labor markets)*

*Represents the existence of feedback loops



INTERVIEW WITH MIKE HALLORAN

“The topic of executive compensation is about as hot as it can be.”

MIKE HALLORAN IS a Senior Partner at Mercer and a leading practitioner in the firm's Human Capital Advisory Services (HCAS) business.

Mike is based in Dallas, and is responsible for the HCAS group in that office. He has consulted on executive compensation and benefit issues for over 25 years, with a focus on linking executive compensation to business strategy and enhanced performance for shareholders, working with company management and board compensation committees.

Mike received a BA degree in Mathematics from Northwestern University and an MBA degree from Northwestern's Kellogg School of Management, specializing in accounting and finance.



C-Suite Insight: Stock options seem to be less popular now than they were a few years ago. To what degree do they encourage overly risky behavior by CEOs?

Mike Halloran: Well, I think the issue of encouraging risky behavior is purely speculative at best, in a lot of ways. Very few companies use stock options exclusively, so it isn't as though the wealth of the executive team has even been based exclusively on what the options produce. And given the oversight that's in the system to begin with, I've always felt that the whole issue of risky behavior driven by options is, again, speculative at best. You can't even find a good cause-and-effect, for the most part.

In terms of trying to drive management behavior, I think you'll find that most feel that the option vehicle, by itself, is just a bit too volatile to really reward creating wealth or creating shareholder value over time.

CSI: If we shift the focus a bit, to time-restricted stock, what is the sweet spot for determining what is long-term, versus what is simply not long-term? What sort of performance metrics are mapped to rewards? What if conditions change in the middle of a period? How do you address all these issues?

MH: There are a couple of things. One, most generally view restricted stock as primarily focused on a combination of both stock price over time and retention, and those periods are generally deemed to be in the three- to five-year space. And with companies granting awards annually, you'll find that many will have vesting over three, four, or five years. So after three years in a program, or four or five, you tend to be vesting in something every year, but you also have another three to five years' worth of shares to be vested.

When companies have also moved to put performance hurdles into the system, it's clearly the case that most will measure performance over three-year periods. So it's also the case that because of what's happened in the economy from the middle of 2008 through now, that many are going to miss those goals because of the downturn. The performance did not meet original expectations, so the shares won't be earned.

At the same time, many structures are such that if you missed the goals, you did have a chance in '09 to set another three-year period, where the goals may have been set more in the realm of where the economy was at that time. The same thing could have happened at the start of this year, 2010, looking at '10, '11, and '12.

CSI: It seems clear that boards, and compensation committees in particular, must link top exec pay to performance in some manner. Do you agree with that statement? And what is the ideal composition of a compensation committee?

MH: It clearly is one of the main responsibilities of a compensation committee, and they take it pretty seriously these days. The issue of linking pay and performance comes in two shapes. One is cash bonuses, tied to annual performance achievements that are typically financial and individual in nature. The second is performance over time, often delivered in shares, with the primary calibration of the ultimate amount received tied to how the stock price performs over a period of time.

As far as who should be on this compensation committee and what it should be like: In today's world, most companies have three to five outside board members who are clearly independent, by any definition that the SEC or the New York Stock Exchange or its equivalents might set. I would say that 95 percent of companies are there now.

CSI: In addition to being independent, what about job titles? What's your opinion of having CEOs on the compensation committee, for example?

I THINK YOU'LL FIND THAT MOST FEEL THE OPTION VEHICLE IS JUST A BIT TOO VOLATILE TO REWARD CREATING WEALTH OR CREATING SHAREHOLDER VALUE OVER TIME.

MH: Many people would tell you that the person best suited to fairly judge if a performance standard is challenging or not would be a CEO who is in the middle of running a business, and who has a perspective on what's going on in the market. Many would say that it's helpful and important to have compensation committee members who were active managers, either currently or recently, of businesses, so that they have a perspective on issues of goal-setting and the like.

CSI: Where are shareholders in this scheme? How much clout do they really have, and how much should they have?

MH: In a big-picture way, shareholders have the ultimate power, because they can vote directors in and out.

On a practical basis, though, shareholders fall into several buckets. Many are professional investors that

tend to be longer-term in nature, but if they're unhappy with management teams or a company's performance, they usually just sell and move on. Many institutions fall into that category.

Then you have activist institutions—say, the pension funds—who feel they're going to be long-term investors everywhere, anyhow. They tend to want to push a point of view, and will often be a bit more aggressive in criticizing management or putting proposals in place that they think might better reflect their interests. Some are clearly self-serving, and some are clearly legitimate. So that's another bucket of shareholders.

And the third category would be the "you-and-me's" of the world, the individual investors. We usually just vote with our feet as well. If we're unhappy with the company, its performance, or its management team, and we pay that much attention, we'll just sell and move on.

CSI: Are you aware of anything in the regulatory or Congressional pipeline that's attempting to give those individual shareholders more say?

MH: Not really, although the SEC has now determined that companies can't count broker-determined votes. So if you have shares parked at Schwab or Merrill Lynch, and you don't vote them personally, they don't count, whereas in the past, the brokers would vote for you unless you asked to do otherwise.

CSI: What role do peer groups play in guiding boards with respect to executive compensation?

MH: At a minimum they play a role, in helping companies validate whether or not they're achieving their objectives, and the degree of difficulty of the financial goals that were set.

If a company says that for good performance, they

want to pay in the middle of a group of comparable companies, you clearly have to determine who's comparable in order to 1) look at their performance and 2) look at their pay.

They're certainly valuable in helping companies validate if they're achieving what they want to achieve.

CSI: Is there such a thing as a perfect peer group?

MH: Certainly, finding peer groups is not easy, because many industries have been consolidating for years. If you're Boeing, for example, is your peer group just Airbus?

There are many other examples where the number of companies who are direct business competitors is very small. So, in most cases, companies look at both business competitors and those who they might compete with for talent.

Going back to my Boeing example, they compete with many other companies besides Airbus for talent.

CSI: There are other examples, though, of a small candy company competing with a large conglomerate. Can you tease out the relevant statistics if you're a small company trying to include a very large company as a peer, or the other way around?

MH: In theory, in addition to industry and talent overlays, you want companies

that are of similar scale and scope. So, to use your candy example: if you were Tootsie Roll, a very small company, do you really compare the CEO of Tootsie Roll to the CEO of M&M Mars, or other companies that are ten times your size?

I think the answer is generally no, but at the same time, the reverse is true. If you're P&G, the largest consumer-goods company in the world, and you compete head-on with Kimberly-Clark in a lot of ways but are still much larger, are you in the same peer group or not? You could certainly say industry, yes; talent, yes; but size of company, maybe not. You do make some accommodations, but on balance, it needs to be fair.

CSI: What best practices have you seen that strike a balance between what compensation consultants say that boards should do, versus what the boards actually do?

MH: Since most compensation consultants report to the compensation committee or the board, much is well-aligned. If you go through a list of the different things that one might consider "best practices"—and anything I'm about to say would not be all-inclusive—you'd go through issues of defining a peer group for purposes of program calibration; vetting and discussing the right mix of options, restricted stock, and performance-based stock

to have in a program; and discussing where you set the bar for incentive plan goals that are challenging, but won't drive the team away—and also won't give the store away at the same time.

I think most boards and consultants are pretty much on the same page, especially considering that most compensation committee members and board members are clearly aware that this topic is about as hot as it could be. Most of them have stepped up the diligence another couple of notches, including becoming voracious readers of things like [this magazine]. They're looking for ways to make sure that there's not anything else they might consider to ensure that they're producing the right outcome.

CSI: This seems to lead to the issue of transparency, one of the key words today.

MH: It clearly is, at least on the internal side. At the same time, board members want to be sensitive to not saying too much that might be of a personal or competitive nature.

But when you get into public disclosures, people want to be more transparent than they have in the past, to help outsiders understand the program. They want to be responsive to SEC requirements—both past and new ones. With respect to what goes on at committee meetings, transparency is clearly the name of the game. **C**

“It’s still important to make sure that the programs and policies are designed to encourage the behavior that the company wants.”



INTERVIEW WITH

THOMAS WELK

THOMAS WELK IS a partner at Cooley LLP, working in the law firm’s San Diego office. He is in the Compensation and Benefits practice group and a member of the firm’s Business department.

As a member of the Compensation and Benefits practice group, Mr. Welk’s practice concentrates in the areas of equity compensation, qualified and non-qualified retirement plans, executive compensation, and welfare benefits. His clients range from start-up enterprises to mature publicly traded companies.

Mr. Welk assists in establishing and maintaining stock option, and other equity incentive and equity-related plans, advises clients as to appropriate compensation arrangements for key employees, and consults on severance arrangements for terminating employees and COBRA issues. He also advises clients on the treatment of compensation and benefits arrangements in mergers and acquisitions and the proper tax treatment of various compensation alternatives.

Mr. Welk was named to the 2009, 2008 and 2007 Southern California Super Lawyers - San Diego list in the category of Employee Benefits/ERISA. In 2006, he was named by his peers and colleagues to the “2006 Top San Diego County Attorneys” list in the category of Corporate Transactional, as published by the San Diego Daily Transcript.

Mr. Welk received an LL.M. (in Taxation) from New York University, a J.D., cum laude, from Gonzaga University, where he was a member of The Gonzaga Law Review, and a B.A. from the University of Washington.

C-Suite Insight: What’s your general viewpoint on putting together peer groups? When can it get unruly?

Thomas Welk: The first principle is to back-check or “sanity-check” your peer group, to make sure that it makes sense. Do members of your peer group identify you as a peer and, if not, why not? Would a computer program come up with the same group? If not, why not?

The second principle is to make sure that you can articu-

late why you’ve identified this peer group specifically. Being able to articulate how you selected your peer group and why you chose that selection method over a different one is a necessary part of the process, because it forces you to re-consider whether your approach is correct and justifiable. Ultimately, many shareholders are going to be interested in seeing how the company identified peer groups, and why they chose a particular route.

CSI: Can you give us an example of what not to do?

TW: Sure. Many people may recall the *Wall Street Journal* story from last year that found at least one member of Tootsie Roll's "peer group" to be as much as 85 times larger than Tootsie Roll itself. A few academic studies have shown that companies tend to select peers with higher paid executives. I think the moral is, unless you can justify why you are doing so, don't pick a peer group that is so "aspirational" that it it's going to stand out.

CSI: It's the "we don't want to see it on the front page of the *WSJ* test."

TW: Well, if you see it on the front page of the *Journal*, are you going to be embarrassed, or are you going to be fine with it? I think that Tootsie Roll is an example of how you have to be mindful of how you set your peer group, and how you need to be able to articulate your process – and how a peer group can stand out.

CSI: Yet there are certainly times when you might have to define a peer as a company that is many times larger than yourself, because you're in the same business, right? Are there times when "peer" doesn't necessarily mean a company of a relatively similar size?

TW: Yes, of course. But you need to be in a position to justify including a much larger company. I was recently reading a proposed CD&A in which a company was planning to say that it didn't have any peers. I questioned whether that was true and

noted that there must be a reasonable list of companies out there against whom they compete for talent.

CSI: Ah, so competing for talent is a valid criterion in this discussion?

TW: Yes, it is. Part of the idea is that you tend to compete for talent within the same industry sector.

CSI: What do you see as the past, current, and future roles of comp committees? Should there be some sort of general governance rules for comp committees?

For example, if you serve on the comp committees of multiple peers, should there be rules for that? Or if you're an executive at one company and you're on the comp committee of a peer, is that something that should be governed?

TW: Compensation committee members should be mindful of perceived conflicts. For example, if a CEO of one company serves on the compensation committee of a peer company and helps set compensation for that other company's CEO, her decision as a compensation committee member may influence her own compensation. I'm not sure that this sort of perceived conflict should be prohibited, but I think it would be best to disclose it and explain why it shouldn't be an issue. If you have enough peer companies, then the compensation of the CEO at one probably won't move the needle too much. If an executive serves on the compensation committees of too many peers, then that

might create a real problem – unless it can be demonstrated by showing that executive compensation from a larger data set is not significantly different.

Further, I think the idea of serving on peer company committees can be helpful. If they're serving on peers' boards, that can, if done right, be very useful. For example, it can see how the peer company identifies its peer group.

Also, you'll often see that peer groups are identified by management or outside consultants.

For that reason, the compensation committee is often provided with a great deal of wonderful, useful, thoughtful information by people who are professionals in the field, so they can have a tendency to notice the quality, thoughtfulness and thoroughness of the work and say, "Great, we'll take it." They have to overcome that tendency.

CSI: But there's a problem with saying that. Sounds like maybe there's a tendency to let things through.

TW: Yes, and that's why I think that, above all, the compensation committee needs to make sure it doesn't effectively abdicate responsibilities to somebody else. The committee needs to go through its own independent analysis.

The compensation committee should continue to take an active role in examining compensation policies and practices. I like the idea that compensation committees are now at least required to consider whether or not

compensation policies and practices are likely to create risk that is reasonably likely to result in a materially adverse effect on the company.

CSI: And in terms of new governance rules?

TW: I don't think they're really adding much. Perhaps enhanced disclosure will help compensation committees think about what role the consultants are asked to play, but I'm not convinced it's going to change current practices.

CSI: When you look at risk and pay for performance, which is a big topic right now, are there specific packages you can think of that have led to undue risk?

TW: As I can recall, the companies who have identified policies or practices as encouraging undue risk are the companies that have defined benefit pension plans.

Outside of the large and generous defined pension plans, I think the data is not clear. For example, conventional wisdom might think a lot of stock options might encourage risk. And I understand that the data doesn't support that.

CSI: This notion of undue risk seems to be a "hindsight is 20-20" game. If you succeed, by definition, it wasn't unduly risky. But if things fail, you can say, "We encouraged undue risk."

TW: That's right. It's a little bit odd and ridiculous to suggest that a board that has fiduciary duties with respect to the company is going to intentionally design policies to encourage behavior so risky that it is reasonably likely to have a material adverse effect on the company.

No board would ever intentionally design such a program. But, compensation committees can certainly use tools to help mitigate any perceived risk.

CSI: You work with start-ups, as well as companies that are fairly large and established. Do you have to adjust your thinking on compensation, or even your thinking on who

the top executives should be, as a company moves from pure start-up mode to becoming a billion-dollar company, and then a five-billion-dollar company?

TW: One of the major differences between start-up and public companies is aligning the interests of the shareholders with the executives. When you're talking with start-up companies, you tend to have a smaller group of shareholders — typically founders and venture capitalists — who are more involved in the management and direction of the company.

They don't mind taking greater risks or paying for the achievement of certain performance goals, even if they can't demonstrate that

THE TECHNICAL STUFF...

CSI: You've written that you "like the idea of using cash-settled SARs in certain circumstances... companies should not necessarily fear liability accounting." Could you tell us exactly what you mean by that?

TW: Sure. I'll start out by saying that I'm not a certified accountant, but I do have a general understanding of accounting rules. Back when we switched over to FAS 123R from APB Opinion 25, there was a fear that stock options were soon to be dead, because we had to start accounting for them, measuring the compensation expense at grant and recognizing it over the vesting life.

That turned out not to be the case.

But there had always been that fear. Back under APB Opinion 25, we wanted to make sure that we didn't have a compensation expense at all. But what people feared most was not only a compensation expense, but what they called variable accounting, which is mark-to-market. Each time you went along, you'd have to adjust the compensation expense based on stock price.

Once we switched over to FAS 123R, now ASC Topic 718, I think a general philosophy emerged: it's better to know the compensation expense up front at the time of grant and recognize it over the vesting life than to have it variable.

CSI: So you're no longer thinking of options in terms of equity.

TW: The idea of cash-settled Stock Appreciation Rights is that if you're paying out in cash, it's not going to be treated as an equity award. It's going to be treated as a liability award. You measure and recognize the compensation expense at the various reporting cycles until you have an exercise event.

"Liability accounting" is the term that's used under the current accounting regime. It's the same thing as variable accounting, essentially; you mark to market as you go along.

CSI: OK, our heads hurt now...

TW: My point is that there are some companies that have had stock prices that are not that volatile, and can expect the same for some period of time. And for those companies, the compensation expense with a cash-settled Stock Appreciation Right may be less than with a stock option.

CSI: What if your company is making a lot of money?

TW: Some of those companies also make money, and their stock price appreciates, but not wildly. Some make money and repurchase their shares on the market.

If the stock price is appreciating, and appreciating significantly, your compensation expense may be greater than a stock option, but investors may not care so much, because your stock price is doing well.

there's some way to ensure that the performance will result in long-term, sustained performance. In many cases, they want to make sure they hit short-term performance goals, so that they can move the company to the next level. So, the risk analysis is different. You tend to be betting with your own money. Also, in many cases, the start-up companies need executives with greater vision.

CSI: But when you go public, it's not just your little sandbox anymore.

TW: A public company is a much more disparate group of people who may have differing interests. It's not just your money that you're betting.

There are plenty of examples of an executive who has a great skill set and is critical at the earlier stages of a company, but who will lack the skills necessary to run a much larger organization. The company's needs can outgrow the skills of the executive.

It's still important, in that case, to make sure that the programs and policies are designed to encourage the behavior that the company wants. So it's important to link pay with true performance, without forgetting the long-term benefit to the company. You can put in some tools better tie ensure that the executive keeps an eye on long-term performance, even when the person is someone you believe will be short-term

CSI: Would you say that the smart approach to determining compensation, rather than taking an overall so-

called philosophy, is just to examine it with the different tools you have to work with? And then the art of it is to figure out which tools to employ in which particular case?

TW: Yes. And I love your phrasing of "the art of it." Because it's an art as much as a science. Some of the science is, for example, identifying the peer group; having a computer model help identify peer companies.

But the art is in answering these questions: What do we want to encourage with our pay? What do we want not to happen? How, if at all, can we make this better?

CSI: Yet it can sometimes seem like everybody is doing more or less the same thing.

TW: Sure, I think there is a tendency in many companies to follow the leader. There was a time, for example, when seemingly every company was granting stock options. I recall a quote from one of the *Mission: Impossible* movies. Somebody asked one of the villains what he wanted. And the villain replied: "I want stock! Stock options, to be precise."

That's ridiculous, because essentially he's saying that he would prefer to get stock options so that he can pay for his stock. But stock options were so ubiquitous at the time that this line captured the culture.

But then you saw a shift, to restricted stock units. A wave of companies followed that. Companies now are using more of a portfolio approach, with some stock options, some time-based restricted

stock, and some performance stock. Compensation committees are thinking more critically about what sort of program makes sense for them, instead of just following once somebody does something. What makes sense for us, and why? What is something that can be administered reasonably?

COMPENSATION COMMITTEE MEMBERS SHOULD BE MINDFUL OF PERCEIVED CONFLICTS.

CSI: And administered transparently. And perhaps, administered in a way to keep a lid on compensation...

TW: I think that the idea of all of this enhanced disclosure is not to encourage or require companies to pay executives less. I think it's designed to give shareholders more useful information.

But from my perspective, what it also does is encourage compensation committees to be more thoughtful about what they're doing and why. The idea of simply paying salary, plus a discretionary bonus, plus some stock options, because that's what the company has always done is not good enough. Compensation committees are thinking more carefully about what they are doing, and why. **C**

CEO PAY STRATEGIES

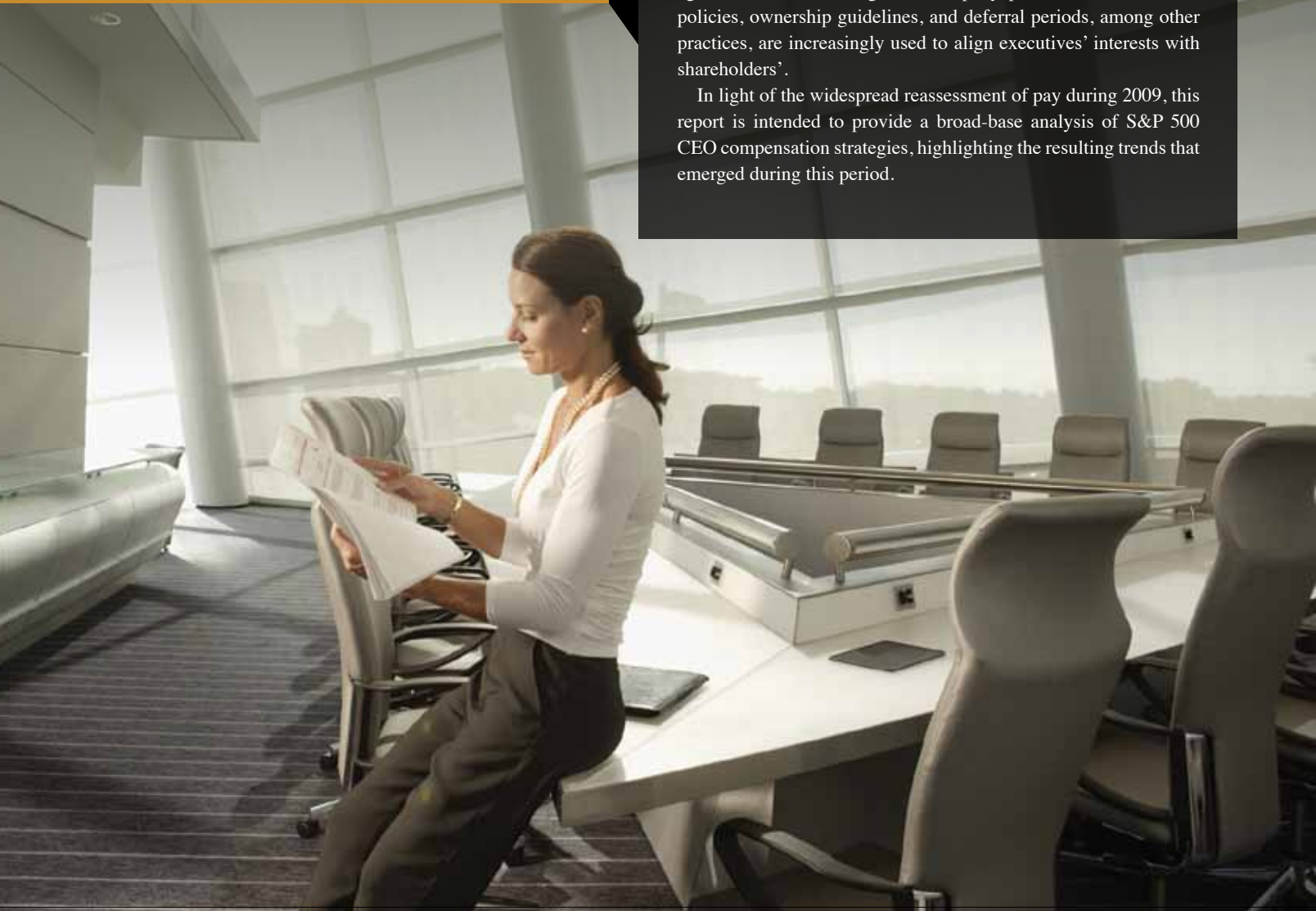
COMPENSATION AT S&P 500 COMPANIES

EXECUTIVE SUMMARY

OVER THE YEARS, companies have continued to refine their compensation programs with the goal of effectively aligning pay with performance. The events of 2009 compelled companies to re-examine their current compensation practices. In the wake of 2008's market volatility, and amidst a nascent 2010 market recovery, the value of balanced pay practices, transparent disclosure, and corporate accountability cannot be overstated.

During 2009, Congress was flooded with legislative proposals to rein in executive pay and align pay with performance. The Securities and Exchange Commission (SEC) and other regulators developed proposals aimed at fostering greater transparency in the process of setting compensation. The most potent of the new SEC rules, initiated last December, deals with disclosure. In recent proxy statements, companies have discussed a reassessment of traditional pay practices, evaluating policies for their ability to incentivize executive behavior that contributed to corporate success. This evaluation has not yielded a comprehensive shift in plan design, but many companies have begun implementing new strategies that focus on long-term company performance. Clawback policies, ownership guidelines, and deferral periods, among other practices, are increasingly used to align executives' interests with shareholders'.

In light of the widespread reassessment of pay during 2009, this report is intended to provide a broad-base analysis of S&P 500 CEO compensation strategies, highlighting the resulting trends that emerged during this period.



COMPENSATION TRENDS

Total Compensation Declines

Median total compensation for S&P 500 CEOs fell by 7.9 percent from 2008 to 2009, marking the second year in a row of overall compensation decline. Median total compensation in 2009 was approximately \$7.5 million, down from \$8.2 million in 2008. For the purposes of this analysis, total compensation is comprised of base salary, annual and long-term cash bonus payouts, the grant-date value of stock and option awards made during the year, and all other compensation.

A sharp decrease in option awards drove much of the overall decline in compensation. The median value of option awards fell from approximately \$2.3 million in 2008 to \$1.9 million in 2009. Other compensation, a category that includes benefits and perquisites, saw a 17.6 percent decline, falling from a median of \$162,287 in 2008 to a median of \$133,659 in 2009. In 2009, many companies reassessed this category of compensation, particularly the payment of tax gross-ups on perquisites.

Bonuses Larger, More Prevalent

Aggregate bonus payouts, which include annual incentive payouts, discretionary bonuses, and long-term cash incentive payouts, rose from a median of \$1,383,000 in 2008 to a median of \$1,500,000 in 2009, an increase of 8.5 percent.

Annual Bonuses Bounce Back

Members of the first group completed their fiscal year amidst the turmoil of the last quarter of 2008. Subsequently, the average annual bonus for this group decreased from 2008 to 2009. Influenced by market trends, the second group of companies continued to see reduced bonus levels. However, companies in the final group (which constituted over 80 percent of the total companies in this study) saw a 13.3 percent increase in average bonus payouts from 2008 to 2009.

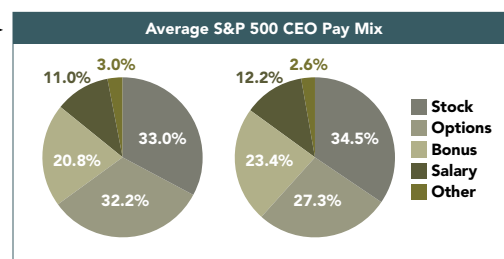
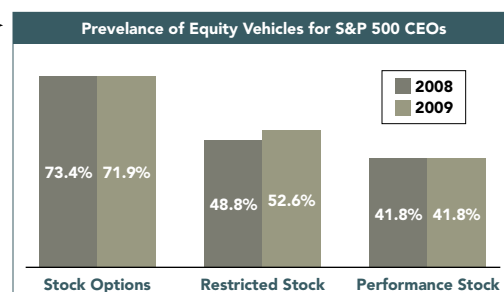
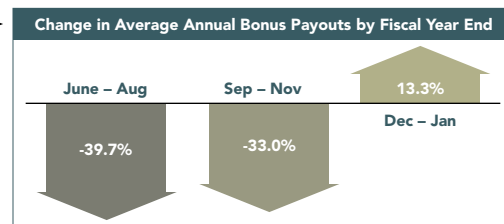
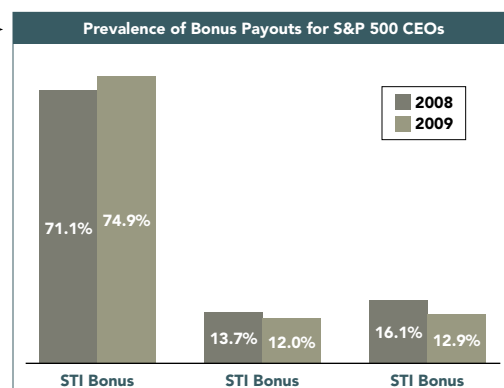
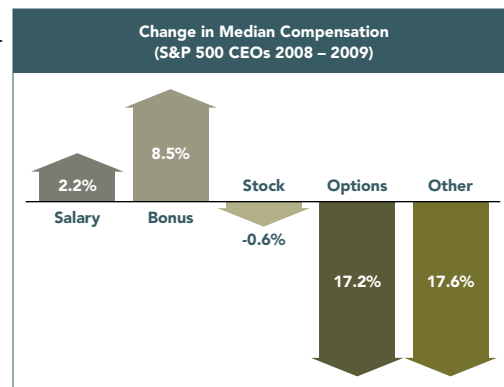
Restricted Stock Sees Rise in Use, Despite Smaller Values

Restricted stock made the biggest gains among equity types employed in 2009, transitioning from a minority-used to a majority-used vehicle. The prevalence of full-value shares grew from 48.8 percent to 52.6 percent among the CEOs studied, continuing the move towards full-value shares and away from options that has been seen in recent years.

A somewhat surprising trend is the stability of performance shares. Despite pressure from the government and shareholders to tie pay with performance, companies appear to be choosing time-vested stock over performance-based equity. Prior to 2009, we saw increases in the use of performance shares as a pay vehicle.

Pay Design Shows Incremental Signs of Change

While the value of pay, and option awards in particular, shifted significantly, the overall design of pay packages remained relatively stable. The only major change was the percentage of compensation paid in options, which fell from 32.2 percent of aggregate S&P 500 CEO pay in 2008 to 27.3 percent in 2009. We also saw the percentage of compensation paid in bonuses grow from 20.8 percent to 23.4 percent over the past year. In general, other pay components saw little change.



Source of graphs: Equilar S&P 500 CEO Pay Strategies Report.

COMPENSATION TRENDS (CONTINUED)

Equity Design Mix Sees Shift to Restricted Stock and Away from Options

The overall design of pay packages did not change significantly in 2009, with only two areas seeing increases. The first was the use of only restricted stock, which grew 50 percent, from 20 to 30 CEOs. The second was the use of all three equity vehicles, which climbed from 39 to 43 recipients. The equity mix that saw the biggest decline was the use of options only; the number of chief executives receiving only options fell from 56 to 50. Another area of decline was the number of CEOs not receiving any equity, which dipped from 34 to 30 chiefs.

PAY FOR PERFORMANCE

Bonuses More Responsive to Performance

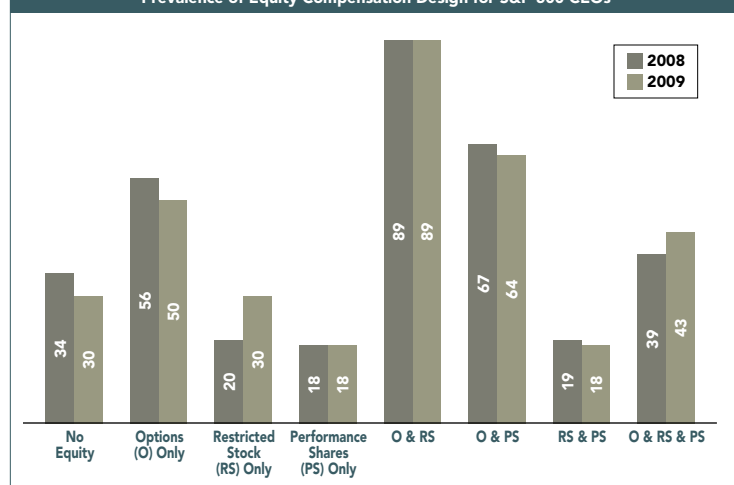
The concept of “pay for performance” has become increasingly important to shareholders. To study this trend, Equilar divided the 342 companies into four equal quartiles, based on one-year TSR performance. Companies with the highest TSR were placed in the top quartile, and companies in the next-highest TSR group were in the second quartile. For this study, the top quartile had a median TSR of 82.7 percent in 2009. This was a substantial improvement over the bottom quartile, which had a median TSR of -9.3 percent for the year. As can be seen in the chart to the left, top-performing companies rewarded their CEOs with bonus payouts that were 86.8 percent higher in 2009 compared to 2008. CEOs in the bottom quartile experienced bonus declines, with the median total bonus falling by 10.4 percent for this group.

Equity Value Grows for 2009 Awards, As 2008 Struggles to Catch Up

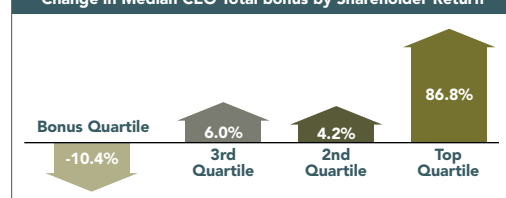
2009 equity grants show a decline over last year, a key facet of the overall drop in pay. Thanks to a market rebound in the second half of 2009, however, executives may end up realizing more pay than they originally estimated. Falling stock prices not only lowered the value of equity awarded but also forced companies to grant more shares, in an attempt to mitigate the difference. Consequently, this increase in shares has begun to provide executives with strong values for their awards—only a year after they were granted. The pessimism surrounding the value of equity granted in 2008 has been replaced by excitement about the fortunate timing of increased shares and decreased exercise prices for equity granted in 2009.

Much like options, 2009 grants of restricted stock saw a favorable climb in value from the grant date to the fiscal year-end, while the 2008 awards experienced a dip. As seen in the chart below, the value of restricted stock granted in 2008 declined an average of 29.7 percent by the end of the fiscal year it was granted. Conversely, the restricted stock given in 2009 saw an average increase of 18.7 percent at fiscal year-end. ■

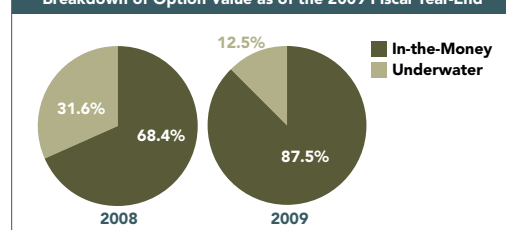
Prevalence of Equity Compensation Design for S&P 500 CEOs



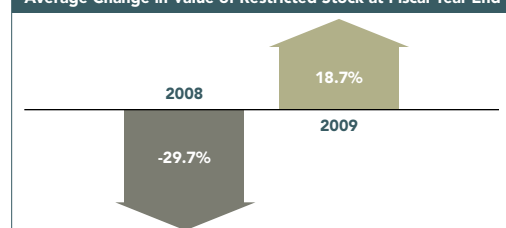
Change in Median CEO Total bonus by Shareholder Return



Breakdown of Option Value as of the 2009 Fiscal Year-End



Average Change in Value of Restricted Stock at Fiscal Year-End



Source of graphs: Equilar S&P 500 CEO Pay Strategies Report.

Want to learn more about CEO pay? See the full report by visiting www.equilar.com, calling (650) 286-4512 or e-mailing info@equilar.com

BONUS PLAN DESIGN FOR 2010

AN ISSUE THAT HAS MOVED BEYOND THE BOARDROOM

THE QUANTITY AND structure of CEO bonuses are issues of increasing importance to the general public. Although Wall Street has received their share of the negative public opinion and political pressure, companies in all industries are now under pressure to demonstrate the link between pay and performance to shareholders.

Unfortunately, public opinion is not the only pitfall facing those who determine executive compensation. As the ability to predict future results decreases, boards now face unprecedented challenges in setting performance goals. These two challenges have engendered a proliferation of new incentive plan practices, which we highlight in this article.

Recent trends in bonus packages include the rising prominence of performance metrics like working capital and cash flow, and the introduction of several new strategies designed to make goal setting more manageable.

This article is designed to help companies navigate through this difficult environment, alerting them to many of the interesting and unique practices that other firms have adopted to face today's challenges.

CEO BONUS PAYOUTS DECLINE

Among the 232 companies included in the most up-to-date data, median total bonus payouts for chief executives fell by 12.6 percent from 2008 to 2009, dropping from \$930,133 to \$812,799. However, among early proxy filers with fiscal years ending in December, bonuses have increased in 2009. Total bonus payouts include both performance-based bonuses and discretionary cash awards.

Fiscal Year End	Number of Companies	Year Over Year Change	Median 2009 Total Bonus
December	86	46.9%	\$1,334,363
June – Nov	146	-29.0%	\$689,000

Performance-based bonus payouts fell by 10.3 percent, declining from a median of \$713,108 in 2008 to a median of \$639,950 in 2009. These bonuses, which made up an average of 81.9 percent of all bonus payouts received by CEOs in 2009, include disbursements from annual and multi-year incentive plans.

The median value of discretionary cash awards declined by 20.5 percent from 2008 to 2009, with the median discretionary payout at \$683,323, down from \$860,000 in 2008. To illustrate these trends, the following chart displays the median total, performance-based, and discretionary bonus payouts for CEOs in 2008 and 2009.

CAPITAL GOODS AND TECHNOLOGY CEOs LOSE GROUND, WHILE FINANCIAL AND SERVICES GAIN

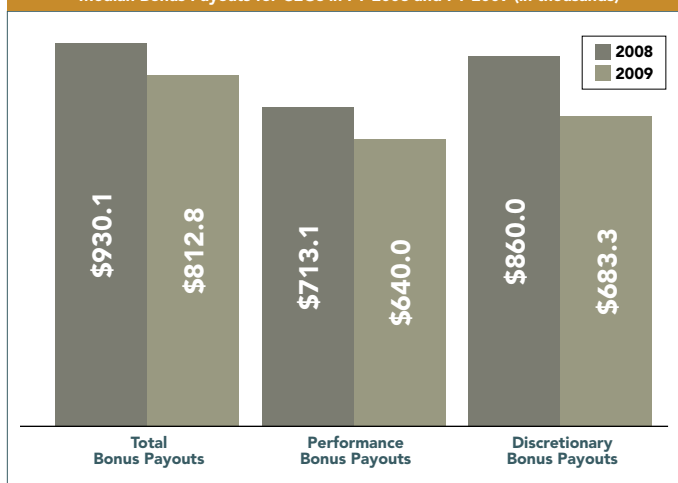
As one might expect, CEOs in certain industries took harder hits than their peers in other fields. For Capital Goods and Technology companies, the median total bonus payout for CEOs decreased by 41.3 and 53.2 percent, respectively, from 2008 to 2009. In contrast, median total bonus payouts grew 21.0 percent for Services companies. Interestingly, the median total bonus payout for early-filing Financial companies increased significantly, from \$0 in 2008 to \$576,294 in 2009. Thus, for 2008, the number of CEOs receiving no bonus was higher than the number of chief executives receiving a bonus. The following chart illustrates the year-over-year change in median bonus payouts for CEOs in specific industries with company fiscal years ending between June 30, 2009 and December 31, 2009.

NUMBER OF EXECUTIVES RECEIVING BONUSES FALLS

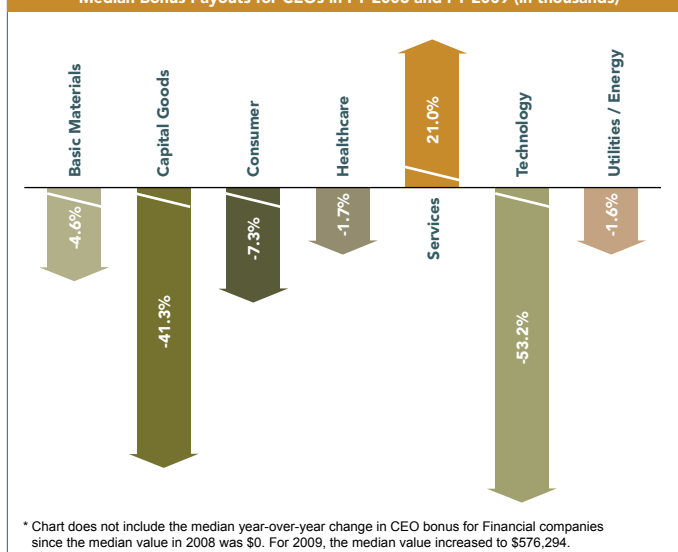
While many CEOs had their bonus payouts decreased, some executives didn't receive a bonus at all; the total number of CEOs receiving bonus payouts fell 3.1% from 2008 to 2009. To illustrate these trends, the following chart displays the prevalence of total bonus payouts, performance-based bonus payouts, and discretionary bonus payouts for CEOs in 2008 and 2009.

Want to learn more about bonus plan design? See the full report by visiting www.equilar.com, calling (650) 286-4512 or e-mailing info@equilar.com

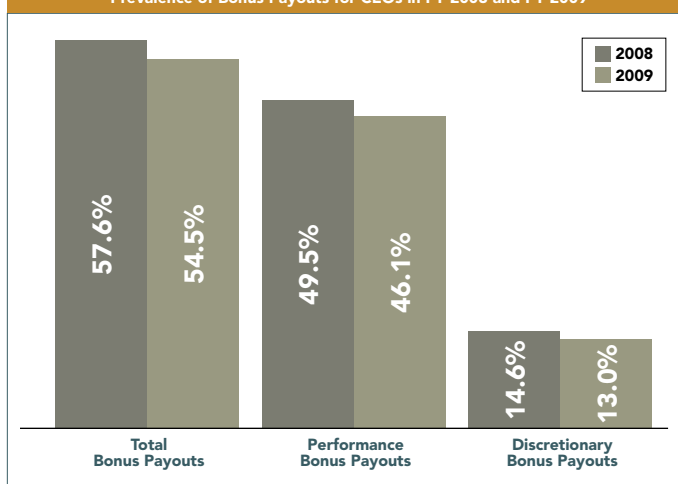
Median Bonus Payouts for CEOs in FY 2008 and FY 2009 (in thousands)



Median Bonus Payouts for CEOs in FY 2008 and FY 2009 (in thousands)



Prevalence of Bonus Payouts for CEOs in FY 2008 and FY 2009



Source of graphs: Equilar 2010 CEO Bonus Report.



INTERVIEW WITH LUCIAN BEBCHUK

“The critical question is whether executives’ payoffs diverged considerably from those of shareholders.”

LUCIAN BEBCHUK IS the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School. Bebchuk is also a Research Associate of the National Bureau of Economic Research and Inaugural Fellow of the European Corporate Governance Network.

Trained in both law and economics, Bebchuk holds an LL.M. and S.J.D. from Harvard Law School and an M.A. and a Ph.D. in Economics from the Harvard Economics Department. He joined the Harvard Law School faculty in 1986 as an assistant professor, becoming a full professor two years later.

Bebchuk’s research focuses on corporate governance, law and finance, and law and economics. Upon electing him to membership in 2000, the American Academy of Arts and Sciences cited him as “[o]ne of the nation’s leading scholars of law and economics,” who “has made major contributions to the study of corporate control, governance, and insolvency.”

C-Suite Insight: Reporter Richard Bernstein wrote in *The New York Times* that the financial crisis provided vindication for the earlier work that you did. In what way did the crisis do so?

Lucian Bebchuk: In our 2004 book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, Jesse Fried and I stressed how the flawed design of standard pay arrangements has not only diluted incentives, but also produced perverse incentives. In particular, we devoted a full chapter to analyzing how pay arrangements provided excessive incentives to focus on improving short-term results, even when doing so came at the expense of long-term shareholder wealth. The financial crisis has demonstrated how severe the adverse effects created by such incentives can be.

CSI: Given that executives of financial firms suffered substantial losses during the crisis, is it plausible to believe that they deliberately chose to take excessive risks earlier on?

LB: Because standard pay arrangements provided executives with a larger fraction of the upside of risks than of the downside of risks, they produced a “moral hazard” problem, inducing executives to take on an excessive level of risk. Because risks did materialize, executives suffered losses, but that doesn’t mean that taking excessive risks was not in their private interest ex ante. The critical question is

whether executives’ payoffs diverged considerably from those of shareholders, in directions that encouraged risk-taking.

CSI: And?

LB: Well, in a recent study, “The Wages of Failure,” Alma Cohen, Holger Spemann, and I provide a case study of how the interests of the top executives of Bear Stearns and Lehman Brothers did, in fact, diverge from those of their shareholders. We found that the top-five executive teams of these firms cashed out large amounts of performance-based compensation during the 2000-2008 period.

During this period, they pocketed large amounts of bonus compensation, which was not clawed back when the firms collapsed, as well as large amounts from selling shares.

CSI: How much money are we talking about here?

LB: Overall, we estimate that the top executive teams of Lehman Brothers and Bear Stearns derived cash flows of about \$1 billion and \$1.4 billion, respectively, from cash bonuses and equity sales during 2000-2008. These cash flows substantially exceeded the value of the executives’ initial holdings in the beginning of the period.

In contrast to how the firms’ long-term shareholders fared, you might say the executives’ net payoffs for the period were decidedly positive.

CSI: Indeed. Going forward, how should pay arrangements be structured to avoid excessive risk-taking, short-term thinking, and most importantly, more anecdotes like the one you just mentioned?

LB: Jesse Fried and I proposed such a design in *Pay without Performance*, several years before the financial crisis. More recently, in an article titled “Paying for Long-Term Performance,” we’ve put forward a detailed blueprint for structuring equity compensation to incentivize long-term value creation.

CSI: How should this be done?

LB: To improve the link between equity compensation and long-term results, the point in time when executives become free to unwind equity incentives should be separated from the point in time when such incentives vest.

CSI: Until they retire, you mean?

LB: No. It would be undesirable to require, as some commentators and reformers have proposed, that executives hold their equity incentives until retirement. Instead, we advocate adopting a combination of grant-based and aggregate limitations on the unwinding of equity incentives.

Grant-based limitations would allow executives to unwind the equity incentives associated with a particular grant only gradually after

vesting, according to a fixed, pre-specified schedule put in place at the time of the grant. Aggregate limitations on unwinding would prevent an executive from unloading more than a specified fraction of the executive's freely disposable equity incentives in any given year. Together, we suggest, these limitations can ensure that executives place sufficient weight on long-term results.

WE'VE PUT FORWARD A DETAILED BLUEPRINT FOR STRUCTURING EQUITY COMPENSATION TO INCENTIVIZE LONG-TERM VALUE CREATION.

CSI: You were a member of group of experts with whom Treasury Secretary Timothy Geithner met to examine how compensation practices can be better aligned before issuing the TARP executive compensation regulations. Subsequently, you served as a pro-bono adviser to the TARP Executive Compensation Special Master, Kenneth Feinberg. Are the Treasury's regulations and Feinberg's rulings no longer relevant, given the broad repayment of TARP funds?

LB: The direct relevance of these regulations and rulings has, of course, declined, but their approach and example hopefully will have beneficial spill-over effects on the compensation practices of firms not subject to TARP.

While it's difficult to disentangle the influence of several factors pushing companies to move in this direction, some progress is being made, and I hope more will follow. For example, when we argued in *Pay without Performance* for separating the time of vesting of equity incentives from the time in

which they become freely exercisable, such separation was quite rare. There are now a significant number of companies using such separation, though they often fail to do so to a sufficient extent.

CSI: As part of your work for the Special Master's Office, you designed an anti-hedging provision for the regulated firms. Is this an arrangement that you would like to see companies imitate?

LB: Yes, definitely. It is desirable for all companies that provide equity awards as part of their pay arrangements to adopt robust limitations on executives' use of hedging and derivative transactions.

As we highlighted in *Pay without Performance*, standard pay arrangements have generally failed to restrict the use of hedging or derivative transactions that weaken, or even eliminate entirely, the incentive effects of equity-based instruments awarded as part of compensation arrangements. And recent em-

pirical evidence confirms that such transactions frequently take place. The use of such transactions is problematic even when they aren't motivated by executives' inside information, but by their desire to diversify risk.

Given a board's chosen structure for an equity-based plan, and the board's setting of pay levels in light of this chosen structure, an executive shouldn't be permitted to undo the structure—which the company spent money to put in place—by using hedging and derivative transactions.

Accordingly, it's important for firms to prohibit hedging and derivative transactions that reduce executives' exposure to fluctuations in the company's stock price. For these prohibitions to be effective, they must be cast broadly enough to encompass all transactions, no matter how labeled, that have the perverse effect of undoing some or all of the intended effects of the company's equity-based arrangements.

ARRANGEMENTS THAT PROVIDED EXECUTIVES WITH A LARGER FRACTION OF THE UPSIDE OF RISKS THAN OF THE DOWNSIDE OF RISKS **PRODUCED A 'MORAL HAZARD' PROBLEM.**

CSI: In another recent project, with Alma Cohen and Charles Wang, you analyze the consequences of golden parachutes.

LB: Yes. Golden parachutes have attracted much debate over the years. Shareholders are often called to vote on precatory resolutions critical of golden parachutes, and proposed legislation would require shareholder votes on all golden parachutes. We have used IRRC data about companies and their governance provisions during the period 1990-2006 to investigate the long-term economic consequences of golden parachutes.

CSI: What did you find?

LB: We found that golden parachutes are associated with increased likelihood of receiving an acquisition offer, as well as increased probability of being acquired.

On the negative side, and consistent with the view that golden parachutes lower the premium threshold over which an acquisition would be in executives' interests, we find that golden parachutes are associated with lower acquisition premia. We further find that golden parachutes have an interesting relationship with the evolution of firm value over time.

CSI: There's that killer word, "interesting." What was interesting about this relationship?

LB: Firms adopting a golden parachute already have a lower industry-adjusted Tobin's Q [a standard measure of value used by financial economists] prior to the adoption. But the value of firms adopting golden parachutes further declines during the two- to three-year period surrounding the adoption, and subsequently continues to erode.

CSI: One more question. In a paper that's forthcoming in the *Journal of Finance*, "Lucky CEOs and Lucky Directors," you study (together with Yaniv Grinstein and Urs Peyer) the backdating of option grants. Isn't backdating a matter of the past?

LB: Yes, it is, but studying backdating can provide some useful lessons for the future. Our study contributes to understanding the relationship between past backdating of option grants and corporate governance failures.

We focus on "lucky" grants awarded at the lowest price of the grant month. When it was first circulated, our study was the first to show that option grant practices were designed to provide lucky grants not only to executives but also to independent directors.

CSI: How fortunate for them.

LB: Fortunate for them but, unfortunately, associated with governance problems: We find that lucky grants were associated with higher CEO compensation from other sources, lack of a majority of independent directors, no outside blockholder on the compensation committee, and a long-serving CEO. We also show that opportunistic timing of lucky grants to both CEOs and independent directors was the product of deliberate choices, not of firms' routines. **C**



INTERVIEW WITH IRA KAY

“Critics may say there’s no pay for performance, but this is a myth.”

IRA T. KAY is the Managing Partner of Pay Governance LLC, a leading independent and objective advisor on executive compensation to boards and management. One of the nation’s foremost experts on executive compensation, Ira served as the global director of Watson Wyatt’s (now Towers Watson) Executive Compensation practice for 16 years. He is a noted author of several books, a frequently quoted source for major U.S. media, and his research focuses on the relationship between executive pay and company performance.

Ira offers valuable insights into performance-based pay, pay/risk assessment and stock ownership through his leading edge and highly regarded research. He is the originator of the concept of realizable pay (vs. pay opportunity) that is now commonly used to assess the alignment between executive pay and performance. He has also helped numerous companies with their shareholder relations, corporate governance, proxy disclosures and their CEO contract negotiations.

Ira holds a B.S. in Industrial and Labor Relations from Cornell University and a Ph.D. in economics from Wayne State University.

C-Suite Insight: You've authored or co-authored several books over the years, one of which, in 1992, described the executive pay "crisis." It sounds like things haven't changed much in the nearly two decades since that statement. Why?

Ira Kay: In the early '90s, when I wrote the book about the executive pay "crisis," it really referred to a misalignment between how the executives were paid and shareholders' interests. The executives did not own enough stock in their companies.

There was a very famous academic article at the time, called "Are CEOs Paid Like Bureaucrats?" And they found that in the '80s and early '90s, they were paid like bureaucrats. We hired bureaucrats. And they performed, most of them, like bureaucrats.

That's why you had the takeover craze that happened in the '80s and the '90s: there was a lot of low-hanging fruit in terms of profitably managing those companies.

Now, the crisis is very different. The crisis is that people, the public and the newspapers and some shareholders, think that the executives are overpaid and not paid for performance.

In my opinion, this is simply not true. If you measure the pay properly, in terms of how much pay the executives can realize, there is very strong alignment. The highest-paid executives work for high-performing companies, and the lowest-paid executives work

for low-performing companies.

While they're under tremendous criticism, it's a very different kind of crisis. The one in the '90s needed fixing. This one needs public-relations management.

CSI: So what would you define as realized pay, as compared to pay figures that you might see in the newspaper?

IK: What we usually see in the newspapers is a combination of two completely different things. They take the actual salary and the actual bonus, and the actual payouts of cash long-term incentive plans. The executives actually receive that cash. And then they add in the grant date, present value, theoretical value of the stock options, restricted stock, and performance shares.

While you can literally add those two numbers together, it's not a meaningful number that you can directly compare to performance. The timing of the bonus payments or incentive payments align with the full-year performance for 2009, but the stock grants are typically made early in the year, and they don't reflect the subsequent performance for the year.

CSI: Why are stock grants given at all, if they're not tied to performance?

IK: They are, in fact, but they're typically tied to the performance of the prior year, say, 2008, but they're made in

2009. To be accurate, sometimes the stock grants relate to prior-year performance, and sometimes companies just give them because they want to be at the median. The beautiful thing about stock options and stock grants is that they really only have major value if the company performs over time and the stock price goes up. You only get them if you earn the performance shares and survive as an executive.

CSI: So there is such a thing as pay for performance.

IK: Critics may say there's no pay for performance, but this is a myth. Even *The Wall Street Journal* and *The New York Times* recently concluded in articles that there was pretty good alignment. If you do this properly, there's very, very strong alignment.

A second myth is that the executive pay model caused excessive risk-taking. I try to be very candid and accurate about the realities behind some of the criticisms about executive pay. But looking at the data, understanding how Wall Street firms work, looking at the billions of employee dollars that were wiped out, I believe that the executive-pay model on Wall Street did not motivate excessive risk-taking.

It didn't motivate them to find the real risk in their balance sheets, but it didn't motivate them to take on excessive risk. This is because they had massive amounts of downside, much of which they gave up.

CSI: We're hearing this from others as well. Some people make the point that the individuals who lost the most money in the 2008 debacle were the leaders of the companies on Wall Street.

IK: There's a theory going around in academic circles now that it's not the executive pay model, but the executives themselves who made a mistake. They misunderstood their risk model and the true risk in their balance sheets. They were overly exuberant.

But the fault wasn't with the executive pay model. These executives wanted to get paid, to be sure, but if they made \$30 million a year (which some of them did) and owned \$1 billion worth of stock, they had an enormous amount of downside. And two of them gave up the full \$1 billion.

Stock ownership levels have risen dramatically over the last two decades, and that has also been very helpful in terms of aligning the interests of the executives with the shareholders.

CSI: So boards should keep doing this.

IK: Exactly. We recommend very strongly that companies keep increasing the stock ownership of their executive team. We've done research that has shown that companies with high stock ownership out-perform those with low stock ownership.

But I don't think executives get enough credit for that. I know CEOs whose stock-ownership value went from \$60 million to \$30 million.

THE CRISIS IS THAT PEOPLE THINK THAT THE EXECUTIVES ARE OVERPAID AND NOT PAID FOR PERFORMANCE. THIS IS SIMPLY NOT TRUE.

They got a \$500,000 bonus that year for improving their earnings per share, and people criticize them for the \$500,000, not taking into account the \$30 million that has been lost.

CSI: What if everyone did nothing except listen to your advice?

IK: This is my macro advice to all of my clients: You need to "understand your culture" and what drives business success. You need to make sure you know whether your programs are working to motivate and link to shareholders and retain the executives.

After that, you need to really get rid of all the irritants. I think it's very easy to defend large stock grants that are very motivating and that yield enormous wealth when they pay off, but it's hard to defend paying the federal income tax on your CEO's golf-club membership. I just don't think that's something that companies should do.

CSI: The irritants seem to be a very small part of the overall picture, but they never go away completely. We wonder if, psychologically, even the best paid-people in the world like free stuff.

IK: They do. It's like all that Hollywood swag the stars get. But today, executives need to be disciplined and learn how to pay for those things themselves, out of their income and the wealth that they generate from stock ownership.

CSI: The silly perks seem to feed this climate of many politicians demanding more regulation.

IK: I recently wrote an article about too much regulation. Basically, I think these efforts aim to solve the wrong problem.

If people think that if they put a cap on salaries, or whatever's going to happen, performance will remain at the same level while either saving the shareholders money or solving the publicity problem, I violently disagree with that.

We have seen the problem of having very low-paid executives: they are fairly low-talent executives. It manifested itself in the bear market of the '70s. Between 1972 and 1982, when executives were paid terribly, they performed terribly.

That doesn't mean there weren't some people who performed well, but in general, the Dow didn't move, profit didn't move, the earnings didn't beat the cost of capital, and so on.

kind of money in the private sector. And if you can only make it in the private sector, it starts to attract you.

CSI: Let's talk about TARP a bit. The scale of this taxpayer bailout is unprecedented. Is regulating the salaries of the leading TARP-funded companies a fair concept?

IK: This is a very complicated topic. I think there are two aspects to it. There's fair, and then there's effective.

The second is that if you initiate a cap on salaries and bonuses, you will lose talented people. Many of those companies, the most damaged of them, did, in fact, lose some of their top executives. Whether they will do better or worse without those people, I don't know, but it certainly makes it very challenging to do those jobs.

CSI: Can you easily summarize the 2008 crisis?

IK: The way I think about it is that the executive pay model did not encourage excessive risk taking. But the executive pay model did not ultimately motivate the executives to find the true risk in their balance sheets. It did not motivate them to override the risk models. It did not motivate them to properly supervise their other highly paid employees, who did have moral hazard.

I did a flowchart on the crisis (see pages 18-19). I think there were about ten different places where it could have been stopped, and it wasn't. If the risk models had been better, if China hadn't been buying treasuries, if the Fed had allowed interest rates to rise faster, if you had more stock ownership on the part of the people selling the credit-default swaps...

But I also strongly believe that our executive-pay model is, overall, very effective. It will clearly help us climb out of our economic hole that much more rapidly. ■

WE HAVE SEEN THE PROBLEM OF HAVING VERY LOW-PAID EXECUTIVES: THEY ARE FAIRLY LOW-TALENT EXECUTIVES.

CSI: We saw this play out in the '90s as well...

IK: Yes, another example is President Clinton's \$1 million salary cap, which was deliberately intended to cut executive pay. He now says that it was his worst piece of legislation, because it actually raised pay. People gave stock options, which qualified for the exemption, and the stock market went up.

CSI: Well, President Clinton's had a change of perspective, now that he's in a different line of work. He probably wouldn't appreciate limits on what he can make.

IK: He actually said this a year ago. He's an example of the fact that you can make that

Yes, I think it's fair. How can you argue against it? They got bailed out. They were helped by the government. More of them would have gone bankrupt.

Obviously, the government didn't help them out to be nice, or to save the pay levels of these highly-paid people. They did it to prevent financial collapse.

The other side of this is what's effective. Here, two things are very clear to me.

One is that many of the policy prescriptions that Kenneth Feinberg put in were already in place. He did initiate the rule of no cash bonuses. But a huge proportion of executive pay on Wall Street was in stock. That's why they lost so much.

COMPENSATION COMMITTEE CHECKLIST

FOR ASSESSING INCENTIVES AND RISK

AS BOARD COMPENSATION committees consider and finalize executive compensation arrangements for 2010, they will seek to confirm that the company's incentive programs are appropriately structured for the company and discourage executives from taking "excessive risk." Many committees will also voluntarily disclose how their compensation programs address the subject of risk. The Center On Executive Compensation, a research and advocacy organization that provides a principles based perspective on executive compensation matters, has created the following checklist to help guide compensation committees on these issues. The questions that form the basis of the checklist are provided below and in greater detail on the subsequent pages.

The Center On Executive Compensation believes that the compensation committee is in the best position to assess the appropriate relationship between the risk inherent in compensation arrangements and how that level of risk corresponds to the overall business strategy and competitive environment of the company. The compensation committee is responsible for establishing company-specific performance goals and potential incentive payouts that will motivate and reward performance supporting the long-term success of the company. The following checklist is offered to aid compensation committees in assessing the extent to which the design and administration of executive compensation encourages or reinforces excessive risk-taking by management.



1. Do the performance criteria and corresponding objectives represent a balance of performance and the quality of such performance?

- The committee should evaluate whether performance criteria under annual and long-term incentive plans include measures of performance (such as financial or managerial goals) and measures of the quality of that performance (such as return measures or measures of sustainability of performance).
 - For example, incentive plans may focus on performance such as revenue, market share or other growth measures, and profitability, return on invested capital, or other measures of efficiency and return.
- This dual approach mitigates the potential that executives will aim to achieve increases in measures such as sales or growth while not focusing on the ultimate value creation or sustainability of such performance.



2. Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?

- Does the annual incentive make up more than 50 percent of the total compensation opportunity?
 - To avoid placing too much focus on achieving short-term results, the annual incentive should not comprise a disproportionate share of the total annual executive compensation opportunity (base salary, annual incentive, estimated value of long-term incentive).
 - Too much emphasis on short-term results may jeopardize long-term performance
 - Recognizing that each company will be slightly different, the median division among the elements of compensation for Fortune 500 companies are:
 - o Salary ≈ 15-20 percent
 - o Annual Incentive ≈ 15-20 percent
 - o Long-Term Incentive ≈ 60-70 percent
 - Annual incentive in excess of 50 percent of annual compensation opportunity should trigger additional Compensation Committee scrutiny and potentially re-allocation of the annual pay opportunity to other components of the pay package.
- Does the annual incentive plan have unlimited payout potential?
 - The annual incentive plan should limit total payouts and the range of payouts should be set at a reasonable level, as determined by the Compensation Committee, to avoid encouraging decisions that maximize short-term earnings opportunities (swinging for the fences) at the expense of long-term viability.
- Do the annual incentive plan criteria and administration mitigate excessive risk?
 - It may be advisable to provide the Compensation Committee discretion in the incentive plan to adjust above-target payouts downward in the face of excessively risky behavior and discuss why this discretion was exercised in the proxy statement.



3. When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?

- The range of performance, and corresponding payouts, should be within a realistic range of results as compared to the performance of the company's peer group.



4. Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?

- While the annual and long-term incentive plans play different roles in the compensation plan, it is important that annual and long-term incentive plan objectives, metrics and targets are aligned to ensure that both types of awards encourage consistent behaviors and sustainable performance results.



5. Do the long-term incentive performance measures or equity devices potentially encourage excessively risky behavior?

- Do the long-term incentive performance measures require excessively risky behavior to realize target or above target payouts? (e.g., do the targets require performance at so high a level that executives would take improper risks to achieve them?)
- Do the performance criteria and vesting periods of long-term incentive awards overlap and thereby reduce the incentive to maximize performance in any one period?
 - With overlapping awards, an attempt to increase short-term performance may jeopardize company performance in future years and thus payouts under other outstanding awards.
- Does the mix of long-term incentive awards meet the Committee's pay for performance objectives?
 - The Compensation Committee should determine the specific mix of long-term incentive awards that serve the best interests of the shareholders and the company, and may include:
 - o performance-vested performance shares or units (which reward the attainment of key financial objectives)
 - o time-vested or performance-vested restricted stock or restricted stock units (which may aid in the retention of key talent)
 - o stock options or stock appreciation rights (which provide value only if share price appreciates thereby producing direct gains to shareholders).



6. Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?

- Require meaningful stock ownership requirements to link executives' interests to shareholders' interests.
- In the Compensation Committee's discretion, require executives to hold a percentage of net equity received as a continuing link between shareholder and management interests.
- The level of share ownership should build over the executive's career
 - As the executive approaches a targeted retirement date the compensation committee may determine it advisable to approve a phased-diversification plan.
 - If the Compensation Committee determines appropriate, ownership may be also be required for some period after retirement
 - o consistent with Internal Revenue Code Section 409A, which requires "key executives" to delay payout of deferred compensation for six months' after departure.
 - Holding requirements should not be so great as to potentially encourage overly conservative management decisions that would harm shareholder value.




7. Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?

- Adopt a strong clawback provision to provide for recoupment in the event of a material restatement.
- The Compensation Committee, in its discretion, should determine when the need for a clawback is triggered, to whom the clawback should apply and the mechanism for recouping incentive payments.



8. Does the Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of a Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?

- In addition to competitiveness and the linkage of pay and business strategy, the relationship between business risk and incentive compensation should be a key consideration in setting performance criteria, the corresponding mix of awards and the range of incentive plan opportunities.
- The Compensation Committee should meet with the company's principal financial officer and/or corporate risk officer prior to approving financial incentive criteria and meet with him/her periodically to facilitate a complete understanding of how the company's financial performance interacts with its strategy and compensation programs.
- Company proxy disclosures should briefly explain how incentive designs mitigate risk to help demonstrate how risk is considered and addressed by the Committee in approving incentive plans. 

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2010 EXECUTIVE COMPENSATION S U M M I T WASHINGTON, DC

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THE PRESS TALKS BACK

THE PRESS. THE MEDIA. THE FOURTH ESTATE. These terms can invoke fear and loathing in corporate suites, particularly if an unfavorable or unflattering story has just appeared in a major publication or on a major network. Yet most people understand that reporters do invaluable work in covering—and uncovering—what’s going on in corporate America, in government, and in all other aspects of society. The press is the representative of the people, which gives its members great power. Most individuals can’t get into the White House briefing or in front of the famous CEO to ask what we want to ask; we can only hope that some sharp reporter will pose these questions on our behalf.

As this issue of *C-Suite Insight* was going to press, we thought it would be fun to ask a few top-level business journalists a few questions of our own.

We know what many business people are thinking when they’re talking to the press: “Be careful, stay on message, and don’t step into any piles of dog poop.”

But what if we flip this around? What do the reporters think when they’re talking to CEOs and other business leaders? And how will they react when they talk to other members of their profession?

What Are Reporters Thinking When They Talk to CEOs?

We were fortunate enough to convince two leading business reporters to respond to our questions:

Tomoe M. Marakami Tse, Financial Reporter
The Washington Post (New York Bureau)

Scott Thurm, Deputy Chief
The Wall Street Journal (San Francisco Bureau)

They responded to us via e-mail.

C-Suite Insight: Do you think public interest in executive compensation will remain high as the economy recovers?

Tomoe: I think so. Perhaps not as much as at the height of the crisis, but once you have a topic enter the public consciousness as much as executive compensation did, it will be tough to erase.

Scott: In general, no. Public interest in executive compensation tends to wax and wane with economic cycles. It's not a perfect fit; public interest tends to lag other economic indicators. But in general, people are less upset about what others get when they feel they are getting ahead. In this cycle, a lot will depend on the shape of the recovery. If wage growth is sluggish and unemployment remains high, interest in executive compensation will remain high as well.

CSI: If you could change one thing about the typical corporate practice when dealing with you/the media, what would it be?

Tomoe: The practice of granting interviews only on a background basis first as a matter of course.

Scott: Engage. Call back. We have a firm policy at the *Journal* of seeking comment from everyone associated with a story, and I've come to embrace that policy. If I misunderstood something or got it wrong, I would much rather know that before publication than after. We're not always going to agree, but I hope we can always have a respectful conversation.

CSI: What advice do you have for corporate executives?

Tomoe: I may be trying to help myself here, but I really truly think it's almost always better to talk to reporters than not talk to them, especially on stories that may not reflect well on the company. I think reporters used to "no comment" or just plain silence on these matters will take notice and will be particularly willing to listen.


CSI: If you could ask Bernie Madoff two questions, what would they be?

Scott: I would bring him together with one of his investors/victims to ask:

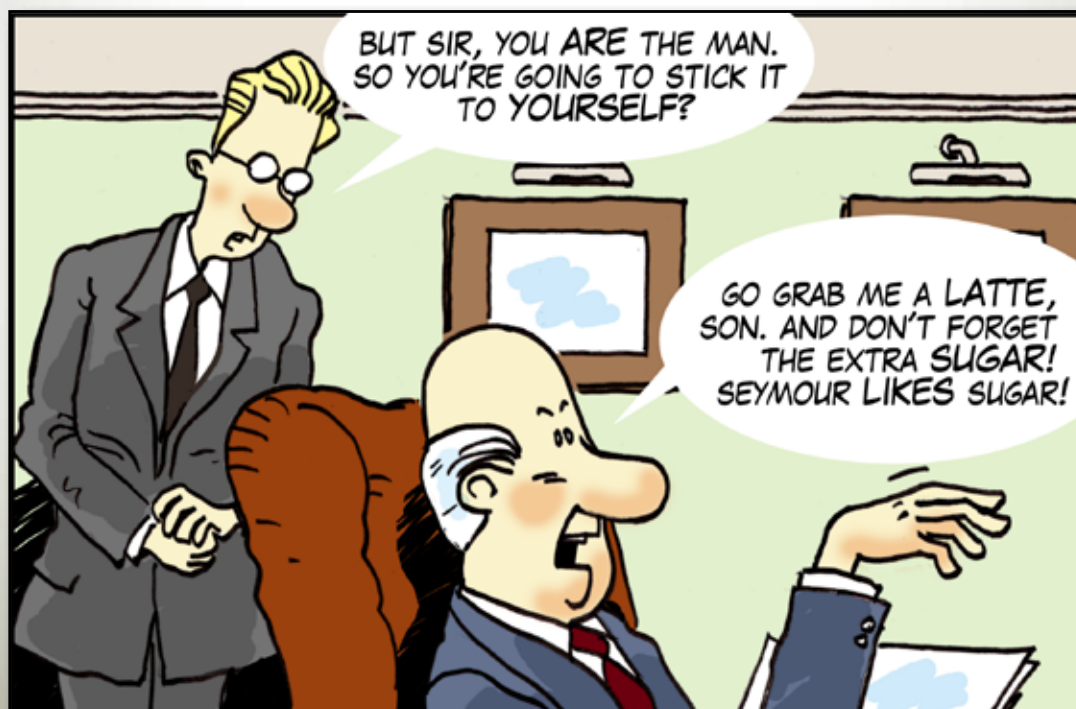
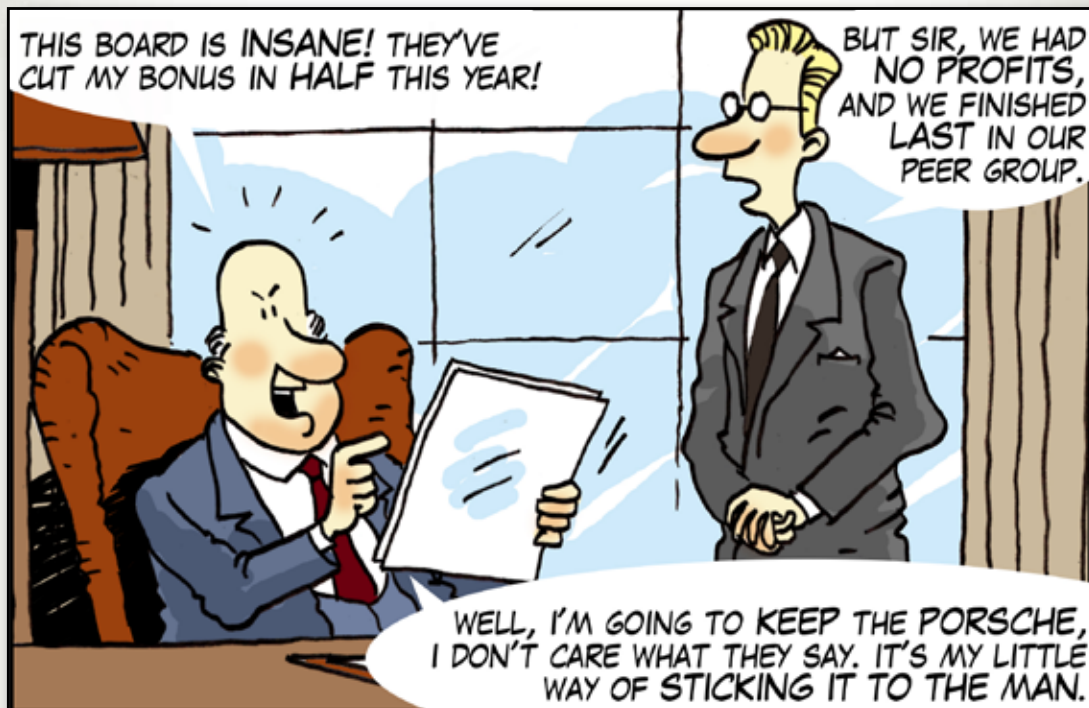
1. "Why?"
2. "From the perspective of today, was it worth it?"

C-Suite Insight: How has the rise of blogs and the 24-hour news cycle changed your work?

Tomoe: Aside from the demands on a reporter's time—writing breaking news for the web, updating stories throughout the day, engaging readers in live web chats—there's a strong demand to drive the print story in the following day's paper forward with a particular news angle or analysis.

Scott: We're all on deadline all the time. With any significant news, the first question is always "How quickly can we publish?" For us, publishing may mean a few headlines on Dow Jones News Service, or a headline and a few paragraphs on wsj.com. We publish more quickly and more frequently, but we haven't relaxed any of our standards for fairness or accuracy. 

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